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Notes

Unless otherwise indicated, all years referred to in this report are federal fiscal years, which run from October 1 to September 30.

The numbers in the text and tables are in nominal dollars (and thus do not reflect adjustments for inflation). Those numbers may not add up to totals because of rounding.

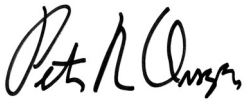
The estimates for budget options shown in this report may differ from any subsequent cost estimates for legislative proposals that resemble the options presented here.

Preface

This volume—one of the Congressional Budget Office's (CBO's) regular reports to the House and Senate Committees on the Budget—presents more than 250 options for altering federal spending and revenues. The volume aims to help policymakers in their annual tasks of making budgetary choices, setting priorities, and adapting to changing circumstances.

The options discussed in this report stem from a variety of sources, such as legislative proposals, the President's budget, Congressional and CBO staff, other government agencies, and private groups. The options are intended to reflect a range of possibilities rather than a ranking or a comprehensive list. The inclusion or exclusion of a particular policy change does not represent an endorsement or rejection by CBO. In keeping with CBO's mandate to provide objective and impartial analysis, the report makes no recommendations, and the discussion of each option summarizes the arguments for and against it.

Budget Options begins with an introductory chapter that provides an overview of the volume and explains how the options work. Chapter 2 presents options that affect spending, organized by the functional categories of the budget (national defense; international affairs; general science, space, and technology; and so forth). The options for each budget function are introduced with a page of background information about spending in that function. Chapter 3 contains options that affect revenues from various kinds of taxes and fees. The appendix lists the many CBO staff members who contributed to the report. This volume is available in multiple formats on CBO's Web site (www.cbo.gov).



Peter R. Orszag
Director

February 2007

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CHAPTER

1

Introduction

The Congressional Budget Office (CBO) issues a compendium of budget options every two years to help inform federal lawmakers about the implications of various policy choices. This report is intended to assist policymakers in assessing the spending or revenue effects of the types of choices they may face in the 110th Congress. Both Houses of Congress have adopted pay-as-you-go rules, which require that proposals involving new mandatory spending or revenues be offset by changes elsewhere in the budget. Furthermore, the Administration and the leadership of the House and Senate Committees on the Budget have expressed a commitment to balancing the total budget by 2012.

In that context, this report presents more than 250 illustrative options covering a broad array of programs and policy areas—from defense to energy to entitlement programs to provisions of the tax code. The options include changes that would decrease spending and others that would increase it, as well as changes that would reduce revenues or raise them. In keeping with CBO's mandate to provide objective, impartial analysis, the report makes no recommendations.

The options in this volume come from various sources, including legislative proposals, the President's budget, Congressional and CBO staff, other government entities, and private groups. They are intended to reflect a range of possibilities, not a ranking of priorities. The inclusion or exclusion of a particular option does not represent an endorsement or rejection by CBO, and the report does not recommend specific changes or provide a comprehensive list of policy alternatives.

The budgetary effects shown for each option span the 2008–2017 period (the 10 years covered by CBO's January 2007 baseline budget projections). However, a number of the options would have significant effects beyond that horizon.

Comprehensive discussions of long-term budgetary pressures—especially those affecting Medicare, Medicaid, and Social Security—appear in other CBO reports.[1] The nation faces a particularly difficult challenge in its health-related programs. Over long periods of time, cost growth per beneficiary in Medicare and Medicaid has tended to track cost trends in private-sector health markets. Therefore, many analysts believe that significantly constraining the growth of costs for Medicare and Medicaid is likely to occur only in conjunction with slowing cost growth in the health care sector as a whole. The health options presented in this volume would generate increases or decreases in federal spending and have different implications for overall health spending. Some would simply result in a reallocation of total costs among different sectors (the federal government, the corporate sector, households, and state and local governments) rather than a reduction in overall costs; others would involve some combination of shifting among sectors and reduction in total costs; and still others would reduce both federal and total health spending in parallel. In future publications, CBO will be expanding the analysis it provides to the Congress and the public on options that could help restrain overall cost growth in the nation's health system over the long term.

The Options in This Volume

Chapter 2 of this report consists of spending options, which are classified according to the functional categories of the federal budget—national defense (050); international affairs (150); general science, space, and technology (250); and so on. For each function, an introductory

1. See, in particular, *The Long-Term Budget Outlook* (December 2005), *Testimony on Implications of Demographic Changes for the Budget and the Economy* (May 19, 2005), *Testimony on the Future of Social Security* (February 3, 2005), and *Updated Long-Term Projections for Social Security* (June 2006).

page provides summary information and data on total nominal spending within that function since 2002. Chapter 3 discusses options that affect revenues from many different kinds of federal taxes and fees. (Revenue options that are related to the subject matter of the various budget functions are noted on the introductory pages to the functions in Chapter 2.)

Each option opens with a table showing the option's estimated effect on spending or revenues in each year from 2008 to 2012, as well as the total effects over those five years and over the 2008–2017 period. The accompanying discussion provides general background information; describes the policy change envisioned in the option; identifies whether it would affect mandatory spending, discretionary spending, or revenues; and summarizes arguments for and against the change. When appropriate, the discussion includes references to related options and to relevant CBO publications.

For options that deal with mandatory spending, CBO estimated the budgetary effects relative to baseline levels of spending that are estimated to occur under current law.[2] For options affecting nondefense discretionary spending, the changes were generally calculated relative to 2007 appropriation levels adjusted for inflation. Those levels were based on the continuing resolution that was in effect through February 15, 2007; they do not reflect the full-year continuing resolution (Public Law 110-5) that was enacted on February 15 or any subsequent legislative action. In the case of options that affect discretionary spending for defense, the budgetary impact was measured relative to the Department of Defense's most recent budget plan (the 2007 Future Years Defense Program), as modified by lawmakers in enacting appropriations for 2007. In all cases, the effects on spending were estimated by CBO. For most of the revenue options, budgetary effects were estimated by the Congress's Joint Committee on Taxation (JCT).[3]

Some of the options in this volume that involve the collection of fees raise a question as to whether the potential fees should be classified as producing revenues (governmental receipts) or offsets to spending (offsetting receipts or offsetting collections). Generally, receipts from a fee that is imposed under the federal government's sovereign power to assess charges for governmental activities should be recorded in the budget as revenues. The Congress has legislated the budgetary classification of some fees, requiring that they be recorded as offsets to spending when they would otherwise have been recorded as revenues. For options in this volume, CBO has attempted to follow the guidance of the 1967 President's Commission on Budget Concepts in classifying new fees.[4]

The options that address spending are intended to facilitate the case-by-case review of individual programs; consequently, they exclude certain types of broad changes that would produce savings in many programs or agencies. Such changes might include, for example, freezing or cutting federal spending across the board or eliminating an entire department or major agency. Nonetheless, some of the options could be combined to provide insight into a broader change. For instance, some analysts have suggested altering the way in which both the tax system and many federal benefit programs are indexed for inflation; such changes are discussed in Revenue Option 6 and Options 600-3 and 650-1. Those options are based on an alternative consumer price index (CPI) that is generally considered to be a closer approximation to a cost-of-living index than other CPI measures are.

Caveats About This Report

Some of the options that would affect state, local, or tribal governments or the private sector might involve

2. CBO's most recent baseline projections were published in *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007). In a few cases, the effects of options were estimated relative to the updated baseline projections that CBO will release in March 2007 as part of its analysis of the President's budget.

3. For cost estimates of legislation that would amend the Internal Revenue Code, CBO is required by law to use estimates provided by JCT. The revenue estimates from JCT in this volume were based on the level of revenues projected in CBO's August 2006 baseline.

4. According to the commission, "Receipts from activities which are essentially governmental in character, involving regulation or compulsion, should be reported as receipts. But receipts associated with activities which are operated as business-type enterprises, or which are market-oriented in character, should be included as offsets to the expenditures to which they relate." (See President's Commission on Budget Concepts, *Report of the President's Commission on Budget Concepts,* October 1967, p. 65.) Thus, in general, if a fee supports a business-like activity, it should be classified as an offset to spending. If it is based on the government's sovereign power to tax, it should be classified as a revenue. Receipts from fees classified as offsets to spending may be further categorized as either mandatory or discretionary, usually depending on the specific legislation that provides for the collections.

federal mandates. Under the Unfunded Mandates Reform Act of 1995, CBO is required to estimate the costs of any mandates that would be imposed by new legislation that the Congress is considering. The discussions of the options in this volume, however, do not address the costs of potential mandates.

In addition, the estimated budgetary effects of the options do not reflect changes in federal interest costs (such as lower or higher interest payments on federal debt). Interest costs or savings are typically estimated as part of a comprehensive budget plan, such as the Congressional budget resolution, but such calculations are not made for individual options of the type discussed in this volume.

Finally, the estimates shown here may differ from any subsequent CBO cost estimates (or later revenue estimates by JCT) for legislative proposals that resemble these options. One reason is that the policy proposals on which those later estimates would be based might not precisely match the options in this volume. Another reason is that the baseline budget projections or levels against which such proposals would ultimately be measured might have been updated and thus would differ from the ones used for this report.

CHAPTER

2

Spending Options

050

National Defense

The military activities of the Department of Defense and the atomic energy activities of the Department of Energy (DOE) constitute most of the spending in function 050, which, after declining at the end of the Cold War, began to rise again in the late 1990s. Between 2002 and 2006, discretionary outlays rose from $349 billion to $520 billion (an increase of 49 percent). Some of that increase is attributable to operations in Iraq and Afghanistan and to activities related to the war on terrorism. So far, for 2007, function 050 is funded at $522 billion, including $70 billion for operations in Iraq and Afghanistan and for the war on terrorism. Further funding for such activities is likely to be provided in a mid-2007 supplemental appropriation.

Most components of defense spending have increased in recent years. Spending on pay and benefits for military personnel grew by 44 percent between 2002 and 2006, and spending for operations and maintenance—to meet many of the military's day-to-day costs—rose by 57 percent. (Most of the costs associated with military operations in Iraq and Afghanistan fall into those two categories.) Spending for procurement and for research and development of weapons systems and munitions also increased, from $107 billion in 2002 to $158 billion in 2006. Spending on DOE's atomic energy activities rose from $14 billion in 2002 to $16 billion in 2006.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority								
Military operations in Iraq and Afghanistan, and other activities related to the war on terrorism	17.8	80.3	88.2	77.4	116.1	70.0 [b]	59.8	-39.7
Other defense activities	343.0	374.7	397.5	422.4	440.4	452.4	6.4	2.7
Total	360.8	455.0	485.7	499.8	556.5	522.4	11.4	-6.1
Outlays								
Discretionary	349.0	405.0	454.1	493.6	520.0	533.6	10.5	2.6
Mandatory	-0.5	-0.2	1.8	1.7	1.9	3.2	n.a.	68.9
Total	348.5	404.8	455.8	495.3	521.8	536.8	10.6	2.9

Note: n.a. = not applicable (because of a negative value in the first or last year).

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

b. The amount for military operations in Iraq and Afghanistan represents partial funding. Assuming that supplemental appropriations will be provided, budget authority and outlays for 2007 will be higher.

050 **050-1—Discretionary**

Cancel the Future Combat System Program

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Spending							
Budget authority	-2,909	-3,031	-1,749	-2,338	-6,169	-16,196	-62,229
Outlays	-1,489	-2,549	-2,504	-1,942	-2,521	-11,003	-48,886

The Army regards the Future Combat System (FCS) program as the cornerstone of its effort to transform itself into a force that can deploy combat units to respond quickly to crises anywhere in the world. With its current tanks and other armored vehicles, the Army typically would take three to four weeks to deploy a brigade to a remote location in Africa, Asia, or Eastern Europe. As envisioned, the next generation of combat vehicles that the FCS program would develop would be as lethal and as survivable as current weapons are but weigh as much as two-thirds less and require less fuel and other logistics support. The Army would develop eight new combat vehicle models as well as new unmanned aerial and ground vehicles, sensors, and munitions—all linked by advanced communications networks into an integrated combat system. The Army's fiscal year 2007 budget plan shows costs from 2008 through 2023 for the first FCS increment (to equip slightly more than one-third of the active Army's combat brigades) that could approach $150 billion. The 2008 plan may include less for FCS over the period, and it could develop fewer systems, equip fewer brigades, or both.

This option would cancel the FCS program and invest more in existing heavier combat vehicles that also have a proven record of utility. It would preserve a residual research and development effort for promising technologies that could be added later to existing systems. The option would expand the Army's programs for upgrading Abrams tanks, Bradley fighting vehicles, M113 armored personnel carriers, and M109 self-propelled howitzers—many purchased in the early 1980s—to keep those vehicles in service for another 20 years. Cancelling the FCS would reduce the need for Army budget authority for research and development and for procurement by a total of $23 billion over the next five years, but upgrading current systems would require about $7 billion in budget authority over the same period. On net, the need for budget authority would decline by about $16 billion between 2008 and 2012 and by $62 billion over 10 years.

The feasibility of the FCS program has been questioned by defense experts and by the Government Accountability Office. Many analysts have concluded that current technology does not permit the construction of lightweight combat vehicles that match or surpass current vehicles in reliability and invulnerability to enemy weapons. Furthermore, the Army's experience in Iraq suggests that its strategy for making lightly armored vehicles equally as survivable as the heavily armored Abrams tank may not be feasible. To achieve comparable survivability, U.S. combat vehicles would avoid being targeted by exploiting superior knowledge of enemy activities. The threat in Iraq has come primarily in urban settings from individually launched weapons, and the ability to identify attackers' locations may be beyond any technology now envisioned.

The primary argument against this option is that canceling the FCS program might preclude transforming the Army in any meaningful way. It would mean a significant portion of the Army would continue to use systems originally developed in the 1980s or earlier. Some of those weapons, notably the Abrams tank, are fuel inefficient and maintenance intensive. Improving the data processing and connectivity of those older systems would require the sometimes-difficult process of integrating newer components into old frames. Finally, retaining old systems might eventually lead the Army to lose its technological edge and military dominance.

RELATED CBO PUBLICATIONS: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006; and *The Army's Future Combat Systems Program and Alternatives,* August 2006

050-2—Discretionary

Add Two New Active Army Divisions

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Budget Authority							
Use existing equipment	+4,400	+11,600	+13,900	+12,900	+7,800	+50,600	+86,900
Purchase new equipment	+5,700	+12,900	+15,200	+12,900	+7,800	+54,500	+90,800

The Army currently has 10 active and 8 reserve divisions, most of which include 4 maneuver combat brigades. In addition, the Army has independent combat brigades, which are not part of any division, and armored cavalry regiments that are similar to separate brigades. In all, the Army had 42 active combat brigades and 28 reserve combat brigades planned for 2007. The service draws on those forces for combat or for peacekeeping missions. Almost all other Army units are intended in some way to support those combat brigades and divisions.

Since the mid-1990s, the Army has been increasingly called upon to keep combat brigades deployed overseas for commitments that have included operations in Bosnia, Kosovo, Kuwait, Afghanistan, and Iraq. To keep forces deployed overseas while preserving high levels of training and readiness, the Army rotates units through those operations. Thus, the more commitments the service has, the more often any unit (and any soldier) can expect to be deployed.

This option would increase the Army's force structure by two divisions, or an additional eight combat brigades. One division would be a heavy mechanized infantry division; the other would be equipped with Stryker medium-weight armored vehicles. This option also would create support units that the new divisions would rely on in combat—corps support groups, artillery brigades, engineer battalions, truck companies, and the like. Some of those units would be part of the Army Reserve or National Guard. To man the units, the active Army's authorized end strength would be increased by 50,000, and the reserve component's end strength would be increased by 30,000.

The Army's recent reorganization into modular combat units and a robust program of remanufacturing its armored vehicles in recent years may have provided the Army with enough M1, M2, M3, M109, and M113-series armored vehicles to create the new units in the heavy division without purchasing additional vehicles of those types. If that were the case, fully recruiting, organizing, equipping, and training all of those new units would take about five years, the Congressional Budget Office estimates, and would require about $51 billion in budget authority over that period. If, however, the Army needed to purchase entirely new equipment, it would require additional budget authority of $55 billion over the same period. (Somewhat less than half of the $55 billion would be for procurement of new equipment in the first five years; the remainder would be for the recurring costs of personnel and for maintaining the new units.)

The main argument for this option is that the current Army may be too small to execute all of its assigned missions. The service's peacetime commitments have increased since the mid-1990s, especially since the beginning of the war on terrorism. When the Army must sustain significant overseas deployments, individual soldiers are separated from their families for long periods, units cannot maintain the training schedule the Army expects, and equipment is degraded by the stress of heavy use (and, in some cases, by exposure to harsh environments). Some proponents of adding two new Army divisions suggest that the pace of deployments has exacerbated those problems to an unacceptable extent and that the only way to slow deployment and preserve readiness is to add forces to the service. In the absence of new active-component divisions, the Army would need to mobilize and deploy more reservists, increasing stress on reserve-component units and personnel. Some defense experts argue that it is inappropriate to regularly mobilize and deploy reserve-component units, that the active Army should be large enough to handle peacetime commitments, and that the reserve component should be used only in exceptional cases.

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An argument against this option is that the cost and time needed to increase the size of the Army's combat forces could make the addition of two divisions a poor response to what may be temporary pressures. Although the need to maintain large forces in Iraq has placed considerable stress on the active Army, that burden might be reduced before the new divisions become fully available in 2012. Increasing the force structure also would carry large long-term fiscal obligations, which could extend for many years after this option was enacted.

RELATED OPTION: 050-1

RELATED CBO PUBLICATION: *Options for Restructuring the Army,* May 2005

050-3—Discretionary

Truncate the DDG-1000 Destroyer Program and Buy Fire-Support Ships Instead

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	+250	-1,060	-1,120	-700	-940	-3,570	-3,980
Outlays	+160	-30	-370	-560	-700	-1,500	-3,750

The Navy's proposed new guided-missile destroyer, the DDG-1000 Zumwalt-class (formerly DDX), is designed principally to provide volume fire support to Marine Corps units conducting operations ashore, although it will be able to perform other missions. Displacing some 14,500 tons, it will be larger than any other surface combatant in the Navy, and it will carry 80 missiles and two 155-millimeter advanced guns to provide support up to 83 nautical miles away. In the long-term ship construction plan it sent to the Congress in February 2006, the Navy proposed buying seven DDG-1000s between 2007 and 2013 at a total cost of about $20 billion. The Congressional Budget Office estimates the total cost of those same seven ships at about $30 billion.

This option would have the Navy build only two DDG-1000s as technology demonstrators for the transition to the new class of cruisers, the first of which the Navy expects to order in 2011. Construction of the other five DDG-1000s in the Navy's plan would be canceled. To provide fire support to Marine Corps units, this option also would provide for five LPD-17 San Antonio-class amphibious ships, each modified to carry 16 vertical launch system cells and two Advanced Gun Systems (AGSs). The ship would have the same main battery as the Navy's DDG-1000, and its less expensive platform is already in production. This option would not lead to savings in 2008, but it would save nearly $4 billion in outlays through 2017. To generate additional savings, funding for two lead ships in 2007 could be combined into full funding for one ship, and a sixth DDG-1000 could be canceled.

Critics of the DDG-1000 have said it is too expensive for the amount of capability it will provide. Although the ship is expected to be stealthier than any surface combatant—thus able to operate closer to shore than other ships can—only three of the seven ships would be immediately available at any given time (the remainder would either be in maintenance or in use for predeployment training). Also, current surface combatants carry more long-range missiles than the DDG-1000s will. Aside from its guns (which the modified LPD-17s would have), the principal benefits of the DDG-1000 are its stealth and its new radar and combat systems, which will make it superior to other surface combatant ships at self-defense in the coastal regions where it will mostly operate. Advances in technology, however, might overtake that advantage as new or improved radar and combat systems are deployed. By incorporating the AGSs on the LPD-17 hull, the Navy could provide the same long-range fire support—a capability the service currently lacks—at much lower cost.

The disadvantage of modifying the LPD-17 to provide fire support is that the resulting ship would be less of a surface combatant than a gun platform capable of local self-defense. The ship would not match Zumwalt-class destroyers' stealthiness, it would not be able to embark helicopters, and it would lack a sophisticated combat suite for coastal operations. Such a vessel could be used only after the coastal waters had been made relatively secure by littoral combat ships or other surface combatants. Another disadvantage is that costs for the future cruiser could be higher because overhead rates at the commercial shipyards might rise as a result of producing fewer DDG-1000s.

RELATED OPTION: 050-4

RELATED CBO PUBLICATIONS: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006; and *Options for the Navy's Future Fleet,* May 2006

050

050-4—Discretionary

Cancel the Maritime Prepositioning Force (Future) Ships

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-10	-1,520	-1,310	-3,440	-4,390	-10,670	-14,120
Outlays	0	-750	-1,100	-2,280	-3,480	-7,610	-14,000

Over the next seven years, the Navy plans to spend about $15 billion on a squadron of ships it calls the Maritime Prepositioning Force (Future), or MPF(F). Combined with several ships in the current fleet, the MPF(F) would allow the Navy to deploy a Marine expeditionary brigade to a hostile shore—and keep it supplied for almost three weeks—without seizing or establishing a land base. The Navy proposes to begin buying the MPF(F) in 2009 and to have the force operational by 2019 or 2020. The squadron would be an important component of Navy and Department of Defense plans for "sea basing"—an idea that is still evolving—which aims to increase the Navy's ability to respond to crises quickly, with a larger forcible-entry capability, and with more freedom of action than is currently possible.

This option would cancel the MPF(F) squadron, and nothing would be bought in place of those ships. The option would save $14 billion in outlays between 2008 and 2017. Some defense experts say its small benefit—the ability to transport and sustain one Marine brigade—will not justify its cost. In addition, at least six of the new ships, which would be built to less stringent commercial standards, would be more vulnerable to attack than are the Navy's amphibious warfare ships. The Navy would operate the MPF(F) along with amphibious ships in coastal areas where threats from enemy mines, antiship missiles, small boats, and submarines are more acute than they are on the open seas. Critics also argue that the technological challenges of deploying and sustaining a Marine brigade entirely from the sea will be insurmountable. Instead, the money would be better spent on traditional amphibious warships or on other equipment that could facilitate deployment of larger numbers of troops in hostile environments, albeit not as quickly as might be possible with the MPF(F) squadron.

The disadvantages of this option include disruption of the Navy's new shipbuilding plan. Senior Navy officials have identified stability in the shipbuilding program as a primary goal. In addition, this option would reduce, if not preclude, the Navy's ability to deploy substantial numbers of Marines ashore and to support them entirely from logistics ships at sea. Senior Navy leaders see that capability (and its concomitant freedom of action) as a paramount design objective for its new ships.

Canceling the MPF(F) squadron, however, does not necessarily translate to fewer ships being available for maritime pre-positioning. The Navy maintains three squadrons of ships overseas, each carrying the equipment needed by a Marine expeditionary brigade. To deploy those brigades, the Marines would be flown from the United States to converge with a ship at an established port where equipment would be unloaded. Under this option, the Navy would retain all three squadrons and the regular amphibious warfare ships in its fleet.

RELATED OPTION: 050-3

RELATED CBO PUBLICATIONS: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006; *Options for the Navy's Future Fleet,* May 2006; and *The Future of the Navy's Amphibious and Maritime Prepositioning Forces,* November 2004

050-5—Discretionary

Cancel the F-35 Joint Strike Fighter and Replace with F-16s and F/A-18s

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-5,200	-6,100	-5,400	-4,600	-7,900	-29,200	-51,900
Outlays	-2,200	-4,200	-5,100	-4,900	-5,800	-22,200	-47,200

The F-35 Joint Strike Fighter program is the military's largest for aircraft development. In 2002, a team of manufacturers, led by Lockheed Martin, was awarded a contract to develop three versions of the stealthy aircraft: a conventional model for the Air Force; a longer range, carrier-based model for the Navy; and a short takeoff, vertical landing (STOVL) model for the Marine Corps. Navy and Air Force plans for 2008–2027 anticipate the purchase of about 2,400 F-35s, at a cost of about $230 billion, according to Bush Administration estimates. If research and development funding is included, more than $244 billion would be spent for the F-35.

This option would cancel the F-35 program and substitute upgraded fighter aircraft already in production: the Lockheed Martin F-16 Block 60 for the Air Force and the Boeing F/A-18E/F for the Navy and the Marine Corps. If those aircraft were purchased in the quantities and on the schedule currently planned for the F-35, this option would decrease outlays for development and procurement by $22 billion over the next five years, it would save $47 billion through 2017, and it would save $87 billion through the end of the planned program if each F-35 were replaced with an upgraded alternative fighter plane.

An argument in support of this option is that the new F-16 and F/A-18 aircraft—with upgraded radar systems, precision weapons, and digital communications—will be sufficiently advanced to meet the threats the nation is likely to face in the foreseeable future. The sophistication of the F-35 and the added technical challenges of building three distinct types of aircraft on a common airframe with the same engine model furthermore may result in costs substantially higher than current estimates would predict. In the past year alone, the cost estimate for the total F-35 program grew by about 9 percent. Experience suggests that additional growth is likely.

A disadvantage of this option is that F-16 and F/A-18 aircraft lack the stealth design features that will help the F-35 evade detection by enemy radar systems and thus enhance its safety in the presence of enemy air defenses. The armed services will maintain some stealth capability, however, with the B-2 bomber and F-22 fighter fleets and with planned development of new, highly stealthy unmanned fighters and long-range bombers. Also, substituting F/A-18s for the STOVL version of the F-35 (the F-35B) would make it impossible to include fixed-wing fighter operations from LHA and LHD amphibious assault ships of the Navy's Expeditionary Strike Group task forces—a capability the current AV-8B Harrier offers. The strike groups therefore would need to rely on armed helicopters (which lack the F-35's range, speed, payload, and survivability) or on the availability of other forces, such as aircraft carrier strike groups, for support.

RELATED OPTION: 050-6

RELATED CBO PUBLICATION: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006

050

050-6—Discretionary

Cancel Navy and Marine Corps Joint Strike Fighters and Replace with F/A-18E/Fs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-2,400	-3,000	-2,200	-1,300	-2,100	-11,000	-14,400
Outlays	-900	-1,900	-2,300	-2,000	-1,800	-8,900	-13,900

Bush Administration plans call for the Department of the Navy to purchase a total of 680 F-35 Joint Strike Fighter planes in two variants. The Marine Corps will have the F-35B, a short takeoff, vertical landing (STOVL) aircraft; the Navy will have the F-35C carrier-based aircraft. (The Air Force's F-35A will be a conventional land-based fighter.) Although the F-35s have common design elements, there are substantial differences between them. The F-35B will have a lift fan, articulated engine nozzle, and special flight control systems for STOVL operations. The F-35C will have larger foldable wings and strengthened structures to withstand the particular demands of carrier operations. For 2008–2024, the Navy Department plans to spend about $7 billion to develop and $77 billion to procure its two versions of the F-35.

This option would maintain the Air Force's F-35A procurement as planned but cancel the F-35B and F-35C. Instead, the Navy and Marine Corps would purchase additional F/A-18E/F fighters that currently are in production. If those aircraft were purchased at the F-35's planned rates, this option would decrease outlays for development and procurement by $9 billion over the next five years and it would save $14 billion through 2017. These are net savings that account for the estimated cost increases that would be expected for the Air Force's F-35A as a result of lower total quantities and rates of production. (Higher unit costs for Air Force F-35s from 2018 through the end of the program in 2027 would reduce the total savings under this option to about $13 billion.)

An argument in support of this option is that the relatively new F/A-18E/F design (which has improved radar, weapon, and communication systems) is sufficient to meet likely threats. Continued development of the advanced technology required for the F-35, especially the powered lift systems in the F-35B, may cause costs to grow substantially beyond current estimates. In the past year, the cost estimate for the Navy's remaining share of F-35 program grew by about $8 billion, or 10 percent. Experience suggests that additional cost growth is possible.

A disadvantage of this option is that although the F/A-18E/F was designed to incorporate stealth features not found on older aircraft, it is nevertheless far less stealthy than the F-35. Canceling the F-35 could limit naval aviation operations early in a conflict, before enemy air defenses are suppressed. This shortcoming could be mitigated if the Navy can develop stealthy unmanned combat aircraft. (Achieving that, however, could present greater technical challenges than remain for the F-35.) Moreover, if the F/A-18 is substituted for the STOVL F-35B, the Marine Corps would not have any fixed-wing fighters to operate from its LHA and LHD amphibious assault ships in naval Expeditionary Strike Group (ESG) task forces or from austere locations ashore. (It can do so now with the AV-8B Harrier.) Absent support from carrier- or land-based aircraft, the ESGs would have to rely on armed helicopters, which lack the F-35's range, speed, payload, and survivability.

RELATED OPTION: 050-5

RELATED CBO PUBLICATION: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006

050-7—Discretionary

Terminate the Airborne Laser Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-540	-420	-420	-650	n.a.	n.a.	n.a.
Outlays	-330	-440	-420	-550	n.a.	n.a.	n.a.

Note: n.a. = estimates not available at publication time.

The Airborne Laser (ABL) program, managed by the Missile Defense Agency (MDA), is working to develop a system to destroy enemy ballistic missiles by means of a high-energy chemical laser carried on modified Boeing 747 aircraft. Its mission is to shoot down ballistic missiles during the boost phase, which occurs in the few minutes after launch and before a rocket's motors burn out. Initially, the ABL was envisioned as a defense against short-range theater ballistic missiles; now it is seen as a defense against short-, medium-, and long-range ballistic missiles.

The ABL program was started by the Air Force in 1996 and transferred to MDA in 2002. From 1996 to 2001, the Air Force invested almost $1 billion in the program; MDA spent an additional $2.4 billion between 2002 and 2006. MDA is continuing the program in a series of two-year blocks: 2004, 2006, 2008, and 2010. Block 2004 provided for the integration and initial testing of the first aircraft. Blocks 2006 and 2008 would continue testing the initial aircraft and focus on integrating the ABL into the larger Ballistic Missile Defense System. MDA's current plans include funding for the purchase of a second ABL aircraft, although MDA states that, in a knowledge-based strategy, those plans are contingent upon positive results from a shoot-down test scheduled for 2009.

This option would end the ABL program, immediately saving $330 million in outlays in 2008 and saving about $1.7 billion through 2011. Over the 2012–2017 period, the savings would be larger if the costs to develop, buy, and operate a fleet of ABL aircraft also are considered. In the absence of definitive current information from the Department of Defense (DoD) about technical characteristics, production quantities, and deployment schedules, the Congressional Budget Office cannot definitively estimate the annual future costs of buying and operating an ABL fleet. In earlier budgets, the Air Force indicated that it would deploy an operational ABL fleet by purchasing up to seven additional ABL aircraft at a cost of about $500 million each. DoD recently indicated that the cost of developing and building the first ABL aircraft would exceed $3 billion. Assuming that each aircraft would cost about $1.5 billion, the savings from discontinuing the development program and from forgoing the purchase of seven additional aircraft could exceed $10 billion between 2012 and 2017.

Supporters of this option argue that the technical problems, rising costs, and schedule delays encountered over the past eight years fuel doubt about the program's chances of success. If the ABL must operate closer to a missile's launch site, it may be vulnerable to enemy air defenses. Moreover, the ABL program is not the only one in MDA's broader Boost Defense Segment. MDA also has another new program that is developing a kinetic-energy hit-to-kill interceptor (KEI) that would be launched from land or sea to intercept ballistic missiles during their boost phases. Those interceptors are potentially more promising for boost-phase defenses because they are less technically challenging to develop than is the ABL system. Analysis also indicates that three to four aircraft would be needed to maintain a constant presence at a single location to defend against a potential enemy missile launch. One ABL aircraft would be on station; one or two would be in transit between the base and the orbiting location; and another would be at the base for refueling, reloading laser chemicals, and maintenance. In addition, the ABL aircraft might require air-refueling tankers, depending on where the aircraft were based. A single, fixed, ground- or sea-based interceptor battery could provide similar coverage at lower cost.

Opponents of ending the ABL program argue that although the ABL poses large technical challenges, it will provide a leap in the nation's ability to defend against ballistic missile attack. Furthermore, even if the boost-phase

interceptor program proved a more viable alternative (and some observers argue that its potential need for multiple basing sites around a hostile country would limit its utility), the KEI would not be operational before 2010. Hence, any capability that the ABL might provide in the interim would be useful. The Air Force also points to significant progress in overcoming the ABL's technical difficulties and remains confident that it will be able to build a laser that can disable threats at long range.

RELATED OPTIONS: 050-8 and 050-9

RELATED CBO PUBLICATIONS: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006; and *Alternatives for Boost-Phase Missile Defense,* July 2004

050-8—Discretionary

Terminate Future Satellites of the Space Tracking and Surveillance System Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-310	-640	-840	-820	-200	-2,810	-12,390
Outlays	-190	-490	-730	-810	-550	-2,770	-11,670

The Space Tracking and Surveillance System (STSS), in development by the Missile Defense Agency (MDA), is planned as a constellation of low-Earth-orbit satellites to track enemy ballistic missiles and distinguish enemy warheads from decoys. The program grew out of an Air Force effort initiated in 1996 to develop the Space-Based Infrared System-Low (SBIRS-Low), satellites in low-Earth-orbit for detection and tracking of enemy missiles. SBIRS-Low experienced cost and schedule overruns; two satellites in the flight demonstration system were partly manufactured but subsequently placed in storage.

In 2000, the Congress directed the transfer of SBIRS-Low to the Ballistic Missile Defense Organization (now MDA). In 2002, SBIRS-Low was renamed STSS, and its development continues in a series of four two-year blocks—Block 2006, Block 2008, Block 2010, and Block 2012. In Block 2006, MDA is completing construction of the two satellites that had been partially manufactured under SBIRS-Low. Those satellites, slated for launch in 2007, are intended to demonstrate the ability to track ballistic missiles in flight and to distinguish warheads on those missiles from decoys. Block 2008 will upgrade the initial system's software; Block 2010's goals are classified. Current plans call for launching five satellites in Block 2012, the initial constellation, with three or more satellites possibly added later. The first launch, scheduled for 2012, is timed to replace flight demonstration satellites at the end of their service lives, although MDA indicates that launch could be delayed until 2014.

By the time STSS Block 12 is completed, MDA expects to have developed other deployable surface-based radars for missile defense, including the Sea-Based X-Band (SBX) and the Forward-Based X-Band Transportable (FBX-T) radar systems. By 2012, MDA plans to have upgraded the Cobra Dane, Beale, Fylingdales, and Thule Early Warning Radars to enhance the nation's ability to track ballistic missiles. The Air Force also expects to improve its missile-warning capability with the Space-Based Infrared System-High constellation. The first launch of a SBIRS-High GEO (geosynchronous) satellite is planned for 2009. The sensors on those satellites will be able to track ballistic missiles early in their flight.

This option would terminate Block 2012 of the STSS program and replace it with ground- and sea-based radars. House Report 107-298 refers to an internal Department of Defense (DoD) study that "indicates that ground based radars not only provide a viable alternative to a space based system, but also provide this capability at significantly lower cost and risk."

To estimate the savings from canceling STSS Block 2012, the Congressional Budget Office has assumed that the initial STSS constellation would follow current DoD plans for five satellites and would subsequently be expanded to nine. Based on the expected capabilities of STSS satellites and DoD's estimate of the satellite mass, CBO estimates that each would cost $700 million (in 2007 dollars). Thus, CBO estimates that canceling STSS Block 2012 would save about $4 billion over the next five years and about $14 billion over a decade. The 10-year savings would come from not starting Block 2012 research and development (about $6 billion), from not buying and launching the new satellites (about $8 billion), and from not operating the constellation (about $100 million). However, MDA would still be able to use the demonstration satellites for technology testing and for gathering data from a planned series of tests. If DoD decided subsequently not to deploy a constellation of operational STSS satellites, more than half the savings CBO estimates would not be accrued.

In place of STSS, this option would provide for one additional SBX and four additional FBX-T radars (the same

radars currently being purchased for the Ground-Based Missile Defense System). Because STSS is a space-based system, it offers global coverage (albeit with potential gaps). Although SBX and FBX-T have more limited range, they can be deployed to any region of concern because they are mobile. Nonetheless, the number of radars assumed by this option would not replace the capability of a nine-satellite STSS constellation. It would provide more limited regional coverage of ballistic missile threats than would STSS.

To estimate the cost of the SBX and FBX-T, CBO examined procurement expense for the initial versions of those radars. CBO estimates that one SBX costs $1 billion and that one FBX-T costs $200 million. CBO assumed the radars would be purchased in 2012 and 2013. Combining the two parts of this option, CBO estimates that the net savings over the next five years would be $2.8 billion in outlays and net savings over the next 10 years would total $11.7 billion.

An advantage of this option is the significant savings from not developing and acquiring the full constellation of STSS satellites. That constellation might not be needed because programs that MDA and the Air Force plan to operate simultaneously with STSS also would provide some ability to track and discriminate ballistic missile warheads. This option would augment that capability with additional ground-based radars, which may be more effective than the sensors in the STSS satellites for that purpose.

An argument against this option is that the STSS flight demonstration system could validate the use of space-based infrared sensors for tracking and discrimination of warheads launched on enemy ballistic missiles. Although technical issues associated with the STSS sensors remain to be solved, use of ground-based systems for discrimination also poses technical challenges. Moreover, ground-based radars cannot match the global coverage offered by a full constellation of STSS satellites. The Air Force's SBIRS-High GEO program also has experienced cost growth and schedule delays, and its capability would be insufficient for tracking ballistic missiles throughout all phases of flight.

RELATED OPTIONS: 050-7, 050-9, and 050-10

RELATED CBO PUBLICATION: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006

050-9—Discretionary

Cancel Development of the Ground-Based Midcourse Defense System After Block 2004/2006

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-2,270	-2,070	-1,780	-1,400	-950	-8,470	-13,610
Outlays	-1,160	-1,960	-1,880	-1,610	-1,220	-7,830	-12,930

The Ground-Based Midcourse Defense (GMD) Block 2004 segment of the Ballistic Missile Defense System had two components, a test bed and an operational segment. Among other elements, Block 2004 included interceptor missiles based at Fort Greely, Alaska, and Vandenberg Air Force Base, California; detection and tracking radars located around the United States; battle management command-and-control software; and a communications system used to relay information to and from the interceptors in flight. The Block 2004/2006 segment continued development and fielding of those capabilities, resulting in December 2005 in the completion of the Initial Defense Capability (IDC). Future block developments would extend the system beyond the IDC by providing more interceptors and radars and expanding GMD to a third ground-based interceptor site.

This option would cancel the development of the block upgrades to the GMD system after the Block 2004/2006 effort. The option would continue to operate the interceptors at the two sites and would spend about $300 million a year to develop improvements to the initial capability. This option would cancel additional interceptor missiles and development of a third ground-based interceptor site currently planned for later blocks. The Congressional Budget Office (CBO) estimates that this option would save $1.2 billion in outlays in 2008 and nearly $13 billion between 2008 and 2017. Although the Administration has provided no detailed information on its post-2011 spending plans, CBO's estimate for this option assumes that spending from 2012 to 2017 to operate and continue development of a three-site GMD system would be consistent with the 2007 Future Years Defense Program. If the Department of Defense subsequently changes those plans and decides not to pursue a three-site system, much of the savings CBO estimates for this option would not be realized.

Some defense experts believe that, without improvement of technology and absent testing of its components individually and as a whole, the GMD system is not ready to field. Fielding the IDC alone would allow testing and provide limited tracking and engagement capacity for ballistic missiles launched from North Korea toward Alaska or the West Coast of the continental United States. Moreover, the delay in additional deployments would allow time to improve missile defense technologies for incorporation into a more capable operational system, should the United States decide to deploy one.

Opponents of this option argue that ballistic missile launches from enemy nations pose a current threat to the United States. Thus, developing and deploying all currently planned GMD segments would provide urgently needed protection for the nation and its allies. In particular, only by fielding all GMD segments will the United States be able to defend all of its territory and extend its missile defenses to its allies and deployed forces.

RELATED OPTIONS: 050-7 and 050-8

RELATED CBO PUBLICATIONS: *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006; and *Alternatives to Boost-Phase Missile Defense,* July 2004

050

050-10—Discretionary

Cancel the Space Radar Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-570	-1,070	-1,320	-1,410	-1,330	-5,700	-14,160
Outlays	-340	-840	-1,180	-1,350	-1,350	-5,060	-13,670

The Space Radar (SR) program is intended to provide around-the-clock, all-weather, global surveillance for the U.S. military and intelligence community. SR would complement airborne radar (or sensor) systems, such as the Joint Surveillance and Target Attack Radar System (JSTARS), which provides surveillance and tracking of enemy forces over areas that are inherently more limited than those that space-based systems could cover. The proposed SR would provide periodic high-resolution imaging of large areas. Potentially, it also could detect moving targets, including enemy convoys and troops, to provide information about activities deep inside enemy territory.

This option would cancel SR and retain current surveillance systems, including JSTARS and Global Hawk, to provide battle-planning information. The Congressional Budget Office (CBO) estimates this option would save $340 million in outlays in 2008 and nearly $14 billion between 2008 and 2017.

According to House Report 108-553, the Department of Defense (DoD) is considering a system of nine low-Earth-orbit radar satellites, and current DoD plans call for the first SR satellite launch in 2015. CBO's estimate of 10-year savings for this option is based on the assumption that DoD will develop, procure, and operate the SR system according to those plans. A more detailed description of the information CBO used in constructing this option is presented in a recent CBO study, *Alternatives for Military Space Radar* (January 2007). If DoD subsequently decided not to deploy the constellation, much of the savings CBO estimates for this option would not be realized.

One justification for this option stems from the significant technical challenges and costs associated with collecting radar data over distances of thousands of kilometers compared with collecting data by aircraft over hundreds of kilometers. Other technical challenges are found in down-linking, processing, and analyzing large amounts of data quickly enough to support battle planning. The radar system also would require efficient, lightweight solar cell and battery technology, powerful on-board signal processing, high-bandwidth satellite-to-ground communications, and complex signal-processing algorithms for identifying moving targets.

Another argument for this option concerns the space radar's military value. House Report 108-553 states that the nine-satellite constellation proposed by DoD "would be unable to track vehicles effectively because of significant coverage gaps." This conclusion is supported by the CBO study cited above, which reports that a nine-satellite system, similar to that proposed by DoD, would be impractical for tracking individual ground targets, although the movement of large military units probably could be detected. Some would argue that those limitations reduce SR's tactical value to the military.

An argument against terminating the SR program is that the radar could be seen as the next logical and necessary step in military transformation, which emphasizes the use of superior intelligence to prevail in conflicts. The SR constellation would not require access to bases in the region of a conflict, nor would it be affected by operations delays during transportation of airborne sensors to an area of interest. SR also would be much less vulnerable to attack than airborne sensors operating close to areas of combat would be. Some proponents of SR also argue that the technology needed for power generation and signal processing is already mature and ready for operational use.

RELATED OPTION: 050-8

RELATED CBO PUBLICATIONS: *Alternatives for Military Space Radar,* January 2007; and *Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2007,* October 2006

050-11—Discretionary

Consolidate Military Personnel Costs in a Single Appropriation

More than half of the federal government's cost of compensating military personnel falls outside military personnel appropriations for the Department of Defense (DoD). Other DoD appropriations pay for many noncash benefits, such as use of commissaries, DoD schools, base housing for military families, and some medical care. The Department of Veterans Affairs (VA) funds additional benefits, including veterans' health care and disability payments and benefits provided under the Montgomery GI bill.

Under this option, the DoD-funded costs mentioned above would become part of military personnel appropriations. Some VA programs also might be funded in the defense budget. That realignment would have two related goals: It would provide more complete information about how much money is being allocated to support military personnel, and it would give DoD managers a greater incentive to use resources wisely. The amount this option might save is unknown (so no table of year-by-year savings is shown). But with DoD-funded support of military personnel totaling about $140 billion in 2007, the potential savings from better management are substantial. For example, a savings of just 1 percent would equal more than $1 billion annually.

The current distribution of personnel costs among different appropriations makes it difficult for DoD, the Congress, and taxpayers to track the total cost of supporting military personnel. In the absence of a total picture, it is difficult to assess the resources devoted to health care, housing, and education benefits or to compare military with civilian compensation.

DoD has some recent experience in consolidating costs into military personnel appropriations. In 2003, it adopted accrual funding for the cost of health care for Medicare-eligible retirees. Those payments, which represent the future cost of providing health care benefits to future retirees, were added into the military personnel accounts of each service. (The current costs of providing health care benefits to Medicare-eligible retirees were removed from DoD's operations and maintenance budget and paid out of a new fund.) This option would expand that approach by incorporating additional personnel support costs into military personnel appropriations.

Advocates of this option argue that further consolidation would encourage DoD managers to use military personnel effectively and to substitute less costly federal civilian employees, contractors, or labor-saving technology for military personnel where possible. This option also would help DoD and the Congress by highlighting the extensive array of noncash benefits in the military compensation package.

Critics of this option argue that implementation could be difficult. For example, new financial management systems and a new appropriations structure would be required.

RELATED OPTIONS: 050-12, 050-13, and 050-15

RELATED CBO PUBLICATION: *Military Compensation: Balancing Cash and Noncash Benefits,* January 2004

050

050-12—Discretionary

Target Pay to Meet Military Requirements

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Spending							
Budget authority	+10	-390	-800	-1,250	-1,690	-4,120	-13,720
Outlays	+10	-370	-780	-1,220	-1,660	-4,020	-13,570

The cash pay that military personnel receive includes basic pay, which depends on rank and time in service, as well as bonuses, allowances, and the tax advantage that arises because some allowances are not subject to federal income tax. Basic pay is the most important element of cash pay, averaging about 60 percent of total cash compensation. Lawmakers typically use the employment cost index (ECI) for wages and salaries of private-sector workers in setting the annual military pay raise. In the 1990s, the raise generally was set either at the annual rate of increase of the ECI or 0.5 percentage points below it. However, the Fiscal Year 2001 National Defense Authorization Act set the annual raise for 2001–2006 at 0.5 percentage points above the ECI. To improve retention, several increases in the pay table for officers and enlisted personnel in some pay grades also were authorized. Those legislated changes raised the average basic pay for all enlisted personnel 13 percent between 2000 and 2006 and raised the basic pay for senior enlisted personnel 15 percent in real (inflation-adjusted) terms. Real basic pay for officers has risen 10 percent over the same period.

Another tool the services have used to increase retention is the selective reenlistment bonus (SRB), a cash incentive typically offered to qualified enlisted personnel in occupational specialties with high training costs or with demonstrated shortfalls in retention. Each service branch regularly adjusts its SRBs to address current retention problems, adding or dropping eligible specialties and raising or lowering bonuses. In addition, the Army pays a deployed SRB to all eligible soldiers who reenlist while deployed in support of current operations. Depending on the service, eligible personnel receive the bonuses in a lump sum at reenlistment, or they receive half at reenlistment and the remainder in annual installments over the course of the additional obligation.

This option would substitute reenlistment bonuses for part of the basic pay increase. From 2008 to 2011, it would limit annual basic pay raises to 0.5 percentage points below the increase in the ECI and offer SRBs to service members in occupations where shortages exist. It would increase the services' spending on bonus payments by about $375 million annually from 2008 through 2011 and remove current restrictions on the maximum bonus. Between 2008 and 2011, service members receiving the additional bonuses would receive higher overall pay than would be the case under the current plan. This option would cost $10 million in 2008 and save more than $4 billion between 2009 and 2012. Because bonuses do not compound the same way general pay raises do, however, all service members would have lower overall compensation in 2012 and beyond, unless the bonus program was extended.

The rationale for this option is that increasing selected reenlistment bonuses is a more efficient way to address occupational mismatches than is giving general pay increases, because bonuses allow DoD to target compensation to specific occupational categories. On average, from 2000 to 2005, about 30 percent of enlisted occupations regularly had shortages, while about 40 percent usually were overstaffed. General pay increases would alleviate shortages in some occupations but would worsen surpluses in others. Unlike pay increases, bonuses would be more easily adjusted from year to year to match recruiting and retention goals. Bonuses also would not incur the heavy cost of "tag-alongs," the elements of compensation, such as retirement benefits, that are tied to basic pay.

Another advantage of this option stems from the flexibility of bonuses, which could be focused on the years of service in which personnel make career decisions. And

larger bonuses could provide more meaningful differences in pay among occupations, which could be a cost-effective tool for improving military readiness.

An argument against this option is that expansion of reenlistment bonuses would amplify pay differences among occupations and thus counter the long-standing principle of military compensation that personnel with similar amounts of responsibility should receive similar pay. Moreover, the practice of increasing bonuses deprives service members of the retirement and other benefits that they would receive if the money were part of basic pay throughout a career.

RELATED OPTIONS: 050-11 and 050-13

RELATED CBO PUBLICATIONS: *Recruiting, Retention, and Future Levels of Military Personnel,* October 2006; and *Military Compensation: Balancing Cash and Noncash Benefits,* January 2004

050

050-13—Discretionary

Increase the Use of Warrant Officers and Limit Military Pay Raises

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-60	-130	-200	-280	-350	-1,020	-2,990
Outlays	-60	-130	-200	-270	-350	-1,010	-2,980

Warrant officers account for about 1 percent of active-duty military personnel, serving as senior technical experts and managers in a variety of occupations and, in the Army, as pilots of helicopters and fixed-wing aircraft. In rank, they fall between enlisted personnel and other commissioned officers. They (like the Navy's limited-duty officers) tend to have long careers, during which they gain considerable expertise.

This option would slowly expand the number of warrant officers to help attract and retain highly qualified, skilled personnel, particularly in occupations with attractive civilian alternatives. To achieve savings, it would offer smaller pay raises to senior enlisted personnel than those prescribed by current law.

Programs to help the military meet its labor force needs tend to be more cost-effective when they are focused on particular occupations and skills. Some analysts point out that growing numbers of midcareer and senior enlisted personnel have substantial college training that current military pay scales may not adequately recognize. Recent defense appropriation acts have increased pay for senior enlisted personnel more rapidly than for other groups. Between 2000 and 2006, real (inflation-adjusted) basic pay for senior enlisted personnel rose by about 15 percent; real basic pay for enlisted personnel generally increased by 13 percent.

Instead of paying all midcareer and senior enlisted personnel more, however, the Department of Defense (DoD) could offer warrant officer positions to those people it most wanted to retain or to those in military occupations with the best-paying civilian alternatives. For five years, this option would limit annual pay increases for personnel in grades E-6 and above to 0.5 percentage points below the increase in the employment cost index for private-sector workers. It would convert 10,000 enlisted positions in the top four grades to warrant officer positions. For 2008–2012, the net outlay savings would total $1 billion. A program that expanded opportunities for warrant officers could focus on specific areas, such as information technology, in which a robust civilian sector can make military compensation noncompetitive. DoD has used enlistment and reenlistment bonuses to fill such positions, although it might be argued that current bonuses are too small to provide meaningful differences among occupations.

This option might offer advantages in efficiency that do not yield near-term budget savings. Expanded opportunities for warrant officers might attract two-year-college graduates who could enter as professionals rather than serving long apprenticeships in the enlisted ranks. Service as a warrant officer also might appeal to those who prefer technical specialities over leadership jobs. The resulting more-experienced workforce could reduce the size of the force that DoD needs.

Converting senior enlisted positions to warrant officer positions might create new problems, however. About 16,000 warrant officers were on active duty in June 2005. Adding another 10,000 could make the force top-heavy without providing a commensurate increase in leadership. Some within the military might object to having a larger group of senior technicians who do not have leadership responsibilities. Also, reducing pay raises overall could hamper military recruitment and retention generally.

RELATED OPTIONS: 050-11 and 050-12

RELATED CBO PUBLICATIONS: *Recruiting, Retention, and Future Levels of Military Personnel,* October 2006; *Military Compensation: Balancing Cash and Noncash Benefits,* January 2004; and *The Warrant Officer Ranks: Adding Flexibility to Military Personnel Management,* February 2002

050-14—Discretionary

Reduce Military Personnel in Overseas Headquarters Positions

The last fundamental reorganization of military headquarters occurred under the Goldwater-Nichols Act of 1986. That law gave the unified theater commands—such as the European and Pacific Commands—the lead in planning operations and executing policy and had them report directly to the President. When a crisis develops that requires additional military forces and support, a unified theater commander calls on the four military services, which recruit, train, equip, and support the forces; the commanders then employ the forces in their geographic areas of responsibility. The Department of Defense (DoD) is changing the locations of some of its combat forces overseas, moving some units from one base to another and returning some units to the United States. That effort does not affect the services' overseas component commands.

In practice, unified commanders constitute another management layer over existing overseas service component commands, such as the U.S. Army Europe and the Pacific Fleet. The commanders' requests are relayed through component commands to the services' U.S. headquarters. Because each service maintains its own headquarters in a given region, there are redundancies in many management functions. In some regions, the only personnel in a particular service branch are those at the component command headquarters. Those various overseas headquarters now are staffed by 6,000 personnel, or 10 percent of all headquarters staff.

This option would reorganize the military's command structure by eliminating the overseas component headquarters, a change that could release 4,000 troops for critical missions. This options would not cut end strength. Instead it would free those military personnel for assignment to different duties. Some operating costs might be saved, but because estimating those savings is not straightforward, no year-by-year table is shown.

An advantage of this option is that eliminating overseas component commands would tighten command and control and free troops for other duties. It would streamline communications by eliminating a management layer between the services and the unified commanders. This option would retain some personnel, however, given the assumption that some command responsibilities could not be eliminated.

An argument against this option is that the overseas component commands provide essential support, including dedicated and responsive support for staging operations and integrating personnel and equipment deployed to a region. The unified commanders are thus freed to concentrate on their combat responsibilities. Overseas component commands also bolster theater support services (medical support, engineering, intelligence, fuel handling, and supply transport, for example), and they plan and execute joint and coalition military exercises and treaty obligations as directed by the North Atlantic Treaty Organization and under bilateral agreements.

Another argument against this option is that the envisioned restructuring would be the largest since the Goldwater-Nichols Act, and it could eliminate as many as 45 general-officer positions overseas. Some observers, however, including some senior staff members in the Office of the Secretary of Defense, argue that despite the difficulty, the new threat environment and the need for additional combat troops demand consideration of just such a widespread reorganization.

RELATED OPTION: 050-15

050

050-15—Discretionary

Replace Military Personnel in Some Support Positions with Civilian Employees of the Department of Defense

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	+220	+450	+700	+970	+1,000	+3,340	+8,960
Outlays	+210	+440	+690	+950	+1,000	+3,290	+8,890

Over four years, this option would replace 20,000 of the more than 500,000 uniformed military personnel in support jobs with Department of Defense (DoD) civilian employees and make those military positions available for combat functions. The Congressional Budget Office has identified some jobs that one service branch considers "military essential" that the others do not and some in all branches that could be filled by civilians. Those jobs are in military units that do not deploy overseas for combat, and they do not involve sensitive functions that might raise security concerns.

Some analysts say as many as 90,000 positions could be converted. This option would convert 20,000 of those jobs, making that many military personnel available to satisfy demands for combat units. Although costs would increase overall, some savings would occur as fewer civilians were substituted for a given number of military personnel. Because the civilians would not be encumbered with military-specific duties, they would have more time to perform their jobs.

Nevertheless, the addition of civilians could decrease outlays by $3.3 billion between 2008 and 2012 and by $8.9 billion between 2008 and 2017, as indicated by DoD's experience with similar conversions. That cost could be lower if some converted positions were opened to contractors. In 2004, DoD approved a plan to convert 10,000 Army military to civilian positions between 2006 and 2011, replacing military personnel with fewer civilians than assumed in this option. Depending on the extent to which the conversions are implemented as planned, the cost of implementation would be lower than shown here.

Although proposals to convert military to civilian positions have been made in the past, only a small percentage of DoD's total personnel have been subject to review. In 2006, DoD made an inventory of civilian and military positions, categorizing them by function; determining whether they were inherently governmental; and, if so, deciding whether each had to be filled with a military service member. That inventory could be used to identify new positions for civilian employees of DoD.

The Air Force categorizes as military 54 percent of its positions in the functional category of morale, welfare, and recreation services. Removing that designation could open about 2,000 jobs to civilians. The Army fills 32 percent of its positions in legal services and support with military staff. In contrast, the Navy has 61 percent and the Air Force has 79 percent of those positions staffed with military personnel. Converting the Air Force and Navy jobs in that category could open more than 4,000 jobs to civilians.

Opponents of this option argue that defining, evaluating, and then redesignating positions would be a cumbersome process with hard-to-define savings. They point out that comparisons among the services can be misleading because some functional areas are service specific. The Navy, for example, must rely on military personnel to fill shipboard support positions. Finally, substituting DoD civilian employees for military personnel without reducing end strength would increase DoD's total costs. Proponents of transferring military personnel out of nonmilitary tasks argue that even if military end strength were not reduced, personnel would still be freed to fulfill their primary mission of military combat.

RELATED OPTION: 050-13

050-16—Discretionary

Substitute Sponsored Reservists for Active-Duty Military

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-110	-220	-330	-460	-470	-1,590	-4,150
Outlays	-100	-210	-330	-450	-470	-1,560	-4,110

In 1996, the British Parliament authorized the United Kingdom's Ministry of Defence to establish "sponsored reserves" to permit peacetime military contractors to become activated reservists when they are deployed overseas. The United States has a similar system for dual-status federal employees who serve with Reserve and National Guard units. While a unit is at home, those employees work as federal civilians; when their units are deployed overseas, they are mobilized to active duty.

A new sponsored-reserve program would require Department of Defense (DoD) contractors that supply services or equipment to have on their payrolls a specific portion of employees who also are members of the inactive reserve component of the military. Sponsored reservists would be contract employees while performing routine tasks at home but would agree to be activated to military status and to perform the same jobs during deployment overseas. Currently, many contractors' employees also are reservists, but when they are deployed overseas, they do other jobs or they work with units that are different from those of their peacetime employment.

This option would gradually institute the program to attract and retain highly qualified, skilled personnel in functions that already rely extensively on contractors. It would reduce by 20 percent the number of active-duty personnel in logistics, real property maintenance, and installation and facilities management. Over four years, about 20,000 active-duty personnel would be replaced with sponsored reservists. Converting those positions and reducing active-duty end strength by that amount could save about $1.6 billion in outlays from 2008 through 2012. In addition to their peacetime responsibilities as contractor employees, sponsored reservists would have military responsibilities but only when they were called to active duty. Some of the savings would accrue because, absent those military responsibilities during peacetime, a smaller number of sponsored reservists could replace a larger number of full-time military personnel.

This option would bridge the gap between wholly privatized functions performed by contractors and functions performed by the military. It would place deployed contract workers within the military chain of command (better ensuring military command and control) and afford them the protections of military status. In particular, sponsored reservists would be protected by the Geneva Conventions. Sponsored reservists also could provide military capability in hard-to-fill occupations or in jobs that require exceptional technical expertise. As members of the inactive ready reserve, those personnel would not count against legislated caps on end strength.

Converting active-duty to sponsored-reserve positions could create some difficulties, however. Although DoD has considered creating such a program, there might be concern that its ramifications have not been explored fully. As a first step, smaller demonstration projects might be preferable to the creation of a new personnel category. There also could be concern about creating a class of uniformed personnel that had not had the same training or leadership development afforded the regular military.

If DoD implemented a sponsored-reserve program without reducing active-duty end strength, active-duty personnel would be freed to perform other functions, but the savings shown in the table would not be achieved.

RELATED CBO PUBLICATIONS: *Recruiting, Retention, and Future Levels of Military Personnel,* October 2006; *Logistics Support for Deployed Military Forces,* October 2005; and *The Effects of Reserve Call-Ups on Civilian Employers,* May 2005

050

050-17—Discretionary

Introduce a "Cafeteria Plan" for the Health Benefits of Family Members of Active-Duty Military Personnel

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-26	-110	-276	-308	-325	-1,044	-3,005
Outlays	-21	-92	-240	-295	-318	-966	-2,891

Many families may be overinsured under the current Department of Defense (DoD) military health care system. Given a choice, some might trade generous health benefits for cash compensation. This option would have DoD provide family members of active-duty personnel with a special cash allowance for health coverage. The allowance would be nontaxable (like the current housing allowance), and it could be used in one of three ways. Under the first option, family members could purchase one of the current TRICARE plans (Standard, Extra, or Prime). The second alternative would allow families to use some of the allowance to purchase a new lower cost, low-option TRICARE plan and keep the remaining funds. Like TRICARE Prime, the low-option plan would have managed care features, but it would incorporate substantial deductibles and copayments for health care services obtained either at military facilities or from civilian providers. (Low-option TRICARE would include a "stop loss" component to limit annual out-of-pocket expenditures and thus control the financial consequences of catastrophic illness.) Under the third alternative, military family members could show proof of insurance and apply the allowance to their share of the premiums, copayments, and deductibles of another health insurance plan.

This budget option would save nearly $1 billion in outlays over the next five years. That estimate incorporates the cost of the cash allowances and accounts for the decreased demand for health care by enrollees in the new plan. The low-option plan's higher out-of-pocket expenses would be expected to encourage restraint in health care purchases. The estimate also accounts for the increased cost of the benefit for eligible family members of active-duty personnel who, because they are not using TRICARE, currently cost the system nothing but who would be likely to apply for the cash allowance.

This option would offer several advantages. First, families of active-duty personnel would have more flexibility in choosing the mix of benefits and cash they receive. Second, enrollees in the low-option plan would have an incentive to use medical services prudently because they would be responsible for a significant share of the cost. Third, some of the cost would be shifted to the civilian employers of military spouses, thus reducing DoD spending. Finally, because family members would commit annually to a health insurance plan, total utilization would be easier to predict than it is under the current system, which allows users to join or leave at any time. Thus, this option would improve resource planning within the military health care system and allow DoD to negotiate firmer contracts for pharmaceuticals and civilian medical services. That advantage would exist even if most beneficiaries chose to remain in one of the three traditional TRICARE plans.

This option also would entail potential disadvantages. Enrollees who chose low-option TRICARE coverage would assume additional risks and might face financial difficulties, despite the low-option's stop-loss limit. Families who obtain health insurance through a spouse's employer might have their coverage disrupted in the event of the relocation of the active-duty member to a new post. DoD would have to develop methods to prorate cash allowances and deductibles for beneficiaries forced to change health plans midyear.

RELATED OPTION: 050-18

RELATED CBO PUBLICATIONS: *Consumer-Directed Health Plans: Potential Effects on Health Care Spending and Outcomes,* December 2006; *Military Compensation: Balancing Cash and Noncash Benefits,* January 2004; and *Growth in Medical Spending by the Department of Defense,* September 2003

050-18—Mandatory

Introduce More Copayments into TRICARE For Life

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,055	-1,161	-1,250	-1,350	-1,468	-6,284	-16,013

TRICARE For Life (TFL) was introduced at the beginning of fiscal year 2002 as a supplement to Medicare for military retirees and their family members over age 65. The wraparound program pays nearly all of its users' remaining medical costs and carries few out-of-pocket fees. Because the Department of Defense (DoD) is a passive payer in the program—it neither manages care nor provides incentives for cost-conscious use of services—it has virtually no means to control the program's costs.

This option would help reduce the costs of TFL as well as for Medicare by introducing small copayments for services and by increasing copayments for prescription drugs to match those commonly charged by civilian plans. Because the program is a wraparound benefit, lawmakers or DoD would need to establish new rules to ensure that users paid minimum out-of-pocket charges—for example, $20 for an office visit or $100 for the first day of a hospital stay—before coverage would begin.

Introducing such charges would reduce the federal spending devoted to TFL (including Medicare savings) by about $1 billion in 2008, by $6.3 billion over the next five years, and by $16 billion between 2008 and 2017. Much of those savings would come from reduced demand for medical services rather than from a transfer of spending from the government to military retirees and their families.

Introducing copayments into TFL would increase beneficiaries' awareness of the cost of health care and promote a concomitant restraint in the use of medical services. Research has generally shown that introducing modest cost sharing can substantially reduce medical expenditures without causing measurable increases in adverse health outcomes.

Among its disadvantages, this option could discourage some patients (particularly low-income patients) from seeking medical care and thus negatively affect their health. Beneficiaries who require treatment for chronic conditions, such as hypertension, might forgo purchasing necessary drugs. Some recent research indicates that rapid increases in copayments can lead to significant reductions in beneficiaries' use of prescription medicines.

RELATED OPTION: 050-17

RELATED CBO PUBLICATIONS: *Military Compensation: Balancing Cash and Noncash Compensation,* January 2004; and *Growth in Medical Spending by the Department of Defense,* September 2003

050

050-19—Discretionary

Consolidate and Encourage Efficiencies in Military Exchanges

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	0	-65	-134	-207	-212	-619	-1,768
Outlays	0	-47	-112	-181	-205	-545	-1,677

The Department of Defense (DoD) operates three chains of military exchanges—the Army and Air Force Exchange Service, the Navy Exchange Command, and the Marine Corps exchange system. The chains provide an array of retail goods and consumer services at military bases for combined annual sales of about $12 billion, the Congressional Budget Office estimates.

This option would consolidate the three systems into a single organization. In addition, it would encourage more efficient operation by requiring the combined system to pay all of its operating costs from sales revenues, rather than relying on DoD to provide some services free of charge. After a three-year phase-in period, those changes would save about $180 million annually.

Studies sponsored by the Office of the Secretary of Defense show that consolidation could lead to significant efficiencies by eliminating the costs of maintaining several purchasing and personnel departments, warehouse and distribution systems, and management headquarters. Although consolidation would entail some one-time costs, CBO estimates that the required spending would be offset by inventory reductions.

CBO estimates that DoD provides the exchanges with about $400 million in free services each year. DoD maintains some parts of buildings, transports goods overseas, and provides utilities at overseas stores. DoD also provides indirect types of base support, such as police and fire protection. Under this option, the combined system would reimburse DoD for the costs of direct support and would thus have an incentive to economize on its use. Furthermore, the requirement for the system to pay all of its own operating costs would improve the exchanges' visibility in the defense budget.

When the exchanges' revenues exceed full operating costs, a portion of the surplus goes to fund military morale, welfare, and recreation programs. The surpluses would likely be smaller under this option, so it is assumed that lawmakers would appropriate about $80 million per year in additional funds for those programs.

One obstacle to implementing this option would be the need to find an acceptable formula for allocating among the individual services the funds for morale, welfare, and recreation activities. There could be concern about fair distribution—either of the earnings or of any additional appropriations. There also could be fear that lawmakers would gradually reduce the amount of additional funding for those activities.

Some critics of consolidation argue that the Navy Exchange Command and the Marine Corps system, with their unique service identities, meet the needs of their patrons better than a larger, DoD-wide system could. But consolidation proponents point to the Army and Air Force Exchange Service, which has served both branches for many years. People who shop in exchanges say their main concern is the availability of low prices and a wide selection of goods—a concern that a consolidated system might be able to satisfy more effectively.

RELATED OPTION: 050-20

RELATED CBO PUBLICATIONS: *Military Compensation: Balancing Cash and Noncash Compensation,* January 2004; and *The Costs and Benefits of Retail Activities at Military Bases,* October 1997

050-20—Discretionary

Consolidate the Department of Defense's Retail Activities and Provide a Grocery Allowance to Service Members

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-418	-512	-610	-685	-727	-2,952	-6,810
Outlays	-301	-465	-569	-652	-706	-2,692	-6,504

The Department of Defense (DoD) operates four retail systems on military bases: a network of grocery stores (commissaries) for all of the service branches and three chains of general retail stores (exchanges) for the Army and Air Force, the Navy, and the Marine Corps. This option would consolidate those systems into a single retail chain that would operate more efficiently, without any appropriated subsidy. Like the current separate systems, the consolidated system would give military personnel access to low-cost groceries and other goods at all DoD installations, including those in isolated or overseas locations.

The current commissary and exchange systems operate under very different funding mechanisms. The commissary system, which is run by the Defense Commissary Agency (DeCA), has annual sales above $5 billion, but it also receives an appropriation of about $1.2 billion a year. The three exchange systems have annual sales totaling about $12 billion. They do not receive direct appropriations; instead, they rely on sales revenue to cover their costs.

The exchanges can operate without an appropriated subsidy because they charge customers a higher markup over wholesale prices than commissaries do. The exchange systems also are nonappropriated-fund (NAF) entities rather than federal agencies, so they have more flexibility in business practices for personnel and procurement. Because DeCA is a federal agency, its employees are civil service personnel and it follows standard federal procurement practices. This option assumes that consolidation would eliminate duplicative overhead headquarters functions and that DeCA's civil service employees would be converted to the NAF workforce.

Under this option, the commissary and exchange systems would be consolidated over a five-year period. At the end of that process, the budget authority required to operate the combined commissary and exchange system would be lower by about $1.4 billion per year. Of that amount, about $1.2 billion would come from eliminating the subsidy for commissaries and $200 million would come from eliminating duplicate functions. This option would return half of the $1.4 billion to active-duty service members through a tax-free grocery allowance of about $500 per year, payable to service members who are eligible to receive current cash allowances for food. The grocery allowance would be phased in to coincide with the consolidation of commissary and exchange stores at each base. The remaining $700 million would represent savings for DoD.

To break even without appropriated funds, the consolidated system would have to charge about 14 percent more for groceries than commissaries do now. At the current level of commissary sales, a 14 percent price increase would cost customers an extra $720 million annually.

Active-duty members and their families would benefit from consolidation. Those families would pay about $200 more per year for groceries—but that amount would be more than offset by the new grocery allowance. (A military family would have to spend at least $3,500 per year on groceries in commissaries before a 14 percent price increase outweighed the benefits of a $500 allowance.) Cash allowances would be particularly attractive to personnel who live off base and could shop more conveniently near home or online. All military families—active-duty, reserve, and retired—would benefit from longer store hours, one-stop shopping, access to private-label groceries (which are not currently sold in commissaries), and the greater certainty of a military shopping benefit that did not depend on the annual appropriation process. Another advantage is that the $500 average grocery allowance could be targeted to specific pay grades or

groups, with larger allowances given to enhance retention or to benefit junior enlisted members with large families.

The retail system would benefit as well. Commissaries and exchanges must now compete with online retailers and the large discount chains that have opened discount grocery and general merchandise stores just outside the gates of many military installations. Recent increases in base security procedures and changes in the civilian retail industry have made it more difficult and costly for DoD's fragmented retail systems to provide those services. This option would allow a consolidated system staffed by NAF employees to better compete with civilian alternatives.

Nonetheless, some people might oppose the change, arguing that low-cost shopping on bases has long been a benefit of military service. Under this option, about $425 million of the price increase would be borne by the military retirees who now shop in commissaries but who would not receive grocery allowances. As a result, this option could face strong opposition from associations of retirees. The average family of a retired service member would pay an additional $200 per year for groceries.

RELATED OPTION: 050-19

RELATED CBO PUBLICATIONS: *Military Compensation: Balancing Cash and Noncash Compensation,* January 2004; and *The Costs and Benefits of Retail Activities at Military Bases,* October 1997

050-21—Discretionary

Change Depots' Pricing Structure for Repairs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-91	-188	-285	-290	-295	-1,148	-2,466
Outlays	-67	-157	-252	-281	-291	-1,048	-2,392

When vehicle transmissions, radar equipment, and other weapon system components need repairs, unit commanders can have the work done at their own facilities or send equipment to central maintenance depots. Under current policies, the depots' repair charges exceed actual repair costs, and that can raise total costs to the Department of Defense (DoD) because there is less incentive to use the depots, even when doing so would save money overall.

This option would allow depots to charge only for the incremental cost of repairs (that is, the costs attributable to the specific maintenance action). Currently, repair charges for components (called depot-level repairables, or DLRs) include incremental costs for labor, materials, and transportation and a share of the fixed costs of overhead. Under this option, the DLR charges would include only those costs that change with the number of DLRs in the depot—for instance, materials, transportation, and direct labor costs. Fixed costs, including overhead, would be covered by an annual flat fee to customers. The new pricing policy could save about $1 billion in outlays over five years because commanders would have stronger incentives to send the work out.

A two-part pricing structure, similar to that used by some utility companies, has been proposed by the RAND Corporation, the Center for Naval Analyses, and others. One RAND study concluded that two-part pricing can reduce depot charges by more than a third. The reduction could shift the workload to depots, and that in turn could reduce DoD's total repair expense. According to RAND, the Navy, and the Office of the Secretary of Defense, local maintenance can cost from 25 percent more to twice as much as repairs done at the depots.

DoD estimates local-facility repair costs at $54 billion. If two-part pricing shifted just 2 percent of the workload to centralized depots, about $1 billion in repair costs also would shift each year. DoD could save $240 million in annual outlays, on average, between 2008 and 2017.

Shifting repair work also could improve quality because local facilities often are not as well equipped for some tasks as depots are. The depots' higher prices can give local facilities an incentive to scavenge parts and, eventually, scavenged DLRs could be sent out for repairs, resulting in labor charges from two facilities for one unit.

A disadvantage of this option is that it could be difficult to develop accurate two-part prices. Depot managers, eager to attract work by keeping prices as low as possible, might try to move variable costs into the flat fee or use direct appropriations to pay for variable expenses. They might be reluctant to separate variable repair costs from fixed costs if doing so could highlight excess capacity. Such influences on prices would cloud cost comparisons between depots and local repair facilities. Two-part pricing also would eliminate a primary benefit of current DLR pricing: total cost visibility. By including fixed and workload-dependent costs in charges, the current system is intended to boost cost-consciousness and encourage commanders to be prudent in their use of DLRs. The system has worked, but it also creates an unintended incentive for unit commanders to use local facilities.

RELATED OPTION: 050-22

RELATED CBO PUBLICATIONS: *Review of Proposed Congressional Budget Exhibits for the Navy's Mission-Funded Shipyards,* April 2006; and *Comparing Working-Capital Funding and Mission Funding for Naval Shipyards: An Interim Report,* December 2005

050

050-22—Discretionary

Ease Restrictions on Contracting for Depot Maintenance

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	0	-93	-190	-290	-393	-967	-3,886
Outlays	0	-69	-159	-256	-358	-824	-3,692

Currently, the Department of Defense (DoD) spends about $27 billion annually for equipment maintenance and repairs provided at its central maintenance depots or at facilities operated by private-sector contractors. The "50/50 rule" specified in 10 U.S.C. section 2466 allows DoD to award contracts for up to half of its depot maintenance appropriations to private-sector bidders, although some public–private partnerships are excluded from the calculation. Generally, work that is assigned directly to government depots without competitive bidding from the private sector costs more. Historically, opening depot work to private-sector bidders has been estimated to save at least 20 percent of costs, including cases in which the government depot wins the work. Studies that have tracked post-competition costs have shown that the savings from competition persist beyond the initial contract award.

DoD currently uses the private sector to perform as much depot work as the 50/50 rule allows. If lawmakers were to relax the rule to a 60/40 split, DoD could open more depot work to competitive bidding and stay within the new rule as long as the private sector did not take more than about $2.7 billion worth of work per year. With the new rule, an additional $3.6 billion in repair work could be opened to competitive bidding each year, assuming the private sector wins three-quarters of the contracts. The estimate of future savings is inexact, yet a conservative assumption that competition saves about 20 percent of costs predicts average annual savings through 2017 of about $370 million. Savings would not occur immediately and would be less in the near term because it would take the depots time to prepare for additional competition and to adjust to changes in workload. Alternatively, the 50/50 rule could be eliminated or redefined so the calculation applied to all maintenance (that would include organic and intermediate maintenance now performed mostly by DoD personnel). Savings would be larger under those changes because the depots could subject even more work to bidding.

Proponents of this option argue that the current limits are arbitrary and reduce DoD's flexibility in determining which source is best to provide maintenance. Easing the restrictions would allow DoD to seek the most efficient and most cost-effective source of support.

Opponents are concerned that DoD should maintain an organic skill base within its operational units to perform depot maintenance. They also consider it important that DoD retain the capacity to sharply increase depot maintenance when required, although private contractors often can meet sudden increases in demand. Some opponents also question the comparability of government and private accounting methods (mainly because of the government depots' limited capability for cost accounting) and so question the fairness of the competition. Finally, opponents of this option express concerns that it might lead to the loss of federal civilian jobs at the depots.

RELATED OPTION: 050-21

RELATED CBO PUBLICATIONS: *Review of Proposed Congressional Budget Exhibits for the Navy's Mission-Funded Shipyards,* April 2006; and *Comparing Working-Capital Funding and Mission Funding for Naval Shipyards: An Interim Report,* December 2005

050-23—Discretionary

Create a Defense Base Act Insurance Pool for Department of Defense Contractors Deployed Overseas

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-46	-67	-41	-29	-30	-213	-589
Outlays	-33	-59	-46	-33	-30	-201	-362

The Defense Base Act (DBA) requires that Department of Defense (DoD) contractors purchase workers' compensation insurance for employees who work overseas. Firms traditionally have purchased coverage on the competitive market for each DoD contract separately. But there is evidence that insurance premiums, commonly listed as a rate per $100 in direct labor cost, currently are higher than historical trends would predict. The higher cost of the premiums, which is passed on to DoD as overhead charges, is likely attributable to the increase in the number of contractor operations in the Middle East and to the heightened risk associated with working in dangerous locations.

This option would permit DoD to negotiate with a single broker to provide a large-scale DBA insurance pool for all contractors. The blanket coverage would provide a worldwide DBA rate for a specific period. Creating a larger DBA insurance pool would lower risk premiums and strengthen the buyer's negotiating position. The Department of State and the U.S. Agency for International Development (USAID) secure blanket coverage now, and their contractors pay lower DBA insurance premiums than DoD contractors do. A similar program is in development for Army Corps of Engineers contractors.

The savings generated by this option would depend on the cost advantages of an insurance pool as well as on the number of contractors deployed and the dangers associated with their locations. Under the assumptions that contractors would pass savings along to DoD through reduced overhead charges and that the pace of military activities in support of the global war on terrorism eventually will slow, the Congressional Budget Office estimates that this option would save an average of $36 million in annual outlays between 2008 and 2017.

The major rationale for this option is that pooling risk is an effective way to lower insurance costs. Firms with small numbers of deployed contractors would especially benefit from being included in a pool; when DBA insurance rates are negotiated independently, small firms tend to pay more for premiums than do larger companies.

An argument against this option is that a DBA insurance pool essentially would provide a subsidy to contractors in more-dangerous locales. Moreover, the creation of a DBA insurance pool would present several administrative challenges and would not guarantee savings for DoD. The State Department and USAID are much smaller agencies, and their use of blanket DBA insurance may not extrapolate to defense contracts. It is unclear whether a single insurance provider, or even several providers working together, would be willing to underwrite DBA insurance for all DoD contractors. Firms with large numbers of deployed employees, particularly those in relatively safe locations, might be reluctant to participate in an insurance pool if doing so would limit their negotiating leverage and flexibility. Finally, the costs of initiating and administering a large-scale DBA insurance program (which are not reflected in the estimates shown here) could greatly diminish the savings.

150

International Affairs

Spending by various departments and agencies on international programs is covered in this function, which includes the Department of State's conduct of foreign relations, economic and humanitarian aid given to developing countries, military and other assistance to other nations, radio and television broadcasting and exchange programs, and financial assistance for the export of U.S. goods and services. The Congressional Budget Office estimates that discretionary outlays for function 150 will total about $37 billion in 2007. Repayments of loans and interest income to the Exchange Stabilization Fund account for most of the negative amounts in mandatory spending for this function.

From 2002 to 2007, discretionary spending for international affairs will grow by $10.5 billion, or about 40 percent, CBO estimates. About one-third of that growth ($3.0 billion) derives from supplemental appropriations in 2003 and 2004 for the reconstruction of Iraq, but most of it ($6.1 billion) is for three areas: the conduct of foreign relations and protection of U.S. diplomatic missions overseas, the strengthening of coalition partners in the wars on terrorism and illegal drugs, and overseas HIV/AIDS prevention and treatment programs.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	25.2	33.5	49.3	34.7	35.9	32.8	9.3	-8.7
Outlays								
Discretionary	26.2	27.9	33.8	39.0	36.1	36.7	8.3	1.7
Mandatory	-3.8	-6.7	-6.9	-4.4	-6.5	-5.4	14.2	-17.7
Total	22.4	21.2	26.9	34.6	29.5	31.3	7.2	6.0

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

150-1—Discretionary

Eliminate the Export-Import Bank and the Overseas Private Investment Corporation

150

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Spending							
Budget authority	-53	-61	-79	-96	-106	-394	-942
Outlays	-13	-30	-55	-75	-91	-264	-759

The Export-Import Bank (Eximbank) and the Overseas Private Investment Corporation (OPIC) provide a range of services to U.S. and foreign companies to promote U.S. exports and private investment overseas. Eximbank offers subsidized direct loans to U.S. exporters and foreign importers, guarantees of private loans that finance those exports, and insurance against the risk that foreign buyers will not repay the loans for the exported goods (export credit insurance). The aim is to increase exports of U.S goods and thereby increase the number of jobs in the United States. OPIC offers private U.S. firms subsidized financing for foreign investments and insurance against political risks to those investments, including nationalization. The aim is to support economic development in some countries that are "strategically important" to the United States. Appropriations in 2007 for Eximbank and OPIC are $100 million and $63 million, respectively.

This option would eliminate new activity by Eximbank and OPIC, although they would continue to service their existing portfolios. This change would save $13 million in outlays in 2008 and more than $250 million over five years.

The main rationale for implementing this option is that the activities of those agencies may not provide net public benefits to the United States. The subsidies that Eximbank and OPIC convey to foreign firms and some exporters deliver benefits to foreign consumers and selected U.S. firms. To the extent that subsidized U.S. exports increase, changes in foreign exchange rates raise prices and reduce sales of unsubsidized U.S. exports. Thus, the long-term effect of Eximbank subsidies may be to change the composition rather than the level of U.S. exports or the number of U.S. jobs. Furthermore, OPIC's subsidies to nations of strategic importance to the United States tend to overlap with and duplicate those provided by the U.S. Agency for International Development. They may also retard the development of local financial institutions and markets in those countries.

An argument against this option is that the Eximbank may play a role in leveling the playing field for some U.S. exporters by offsetting the subsidies that foreign governments provide to their targeted industries, thereby maintaining the composition of sales of U.S. goods. By subsidizing U.S. investment in developing and transitional economies, OPIC may also effect some marginal increase in investment in those economies.

RELATED OPTIONS: 350-5, 350-6, 350-7, 370-1, and 920-3

RELATED CBO PUBLICATIONS: *The Decline in the U.S. Current-Account Balance Since 1991,* August 6, 2004; *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees,* August 2004; *The Domestic Costs of Sanctions on Foreign Commerce,* March 1999; *The Role of Foreign Aid in Development,* May 1997; and *The Benefits and Costs of the Export-Import Bank of the United States,* March 1981

250

General Science, Space, and Technology

Function 250 includes federal funding for the broad-based scientific research and development programs of the National Aeronautics and Space Administration (NASA) and the National Science Foundation (NSF) and for the general science programs of the Department of Energy (DOE). (Federal research and development funding for other agency missions or areas, including defense, health, and agriculture research, is included in those respective budget functions.)

More than half of the funding in function 250 is devoted to NASA's space and science programs, including the International Space Station, the space shuttle, space-based observatories, and various robotic missions. NSF, which accounts for 24 percent of 2007 funding in this function, is the government's principal sponsor of basic research at colleges and universities. DOE's general science programs, which are funded at about $3.7 billion for 2007, support specialized facilities and basic research in such areas as high-energy and nuclear physics, advanced computing, and the biological and environmental sciences.

Most spending in function 250 is discretionary. Outlays declined slightly in 2006, but spending over the four preceding fiscal years grew at an average annual rate of 3 percent. In 2007, outlays are projected to reach almost $25 billion, an increase of 3.8 percent from the year before.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	21.9	22.9	23.4	24.2	24.9	25.0	3.3	0.2
Outlays								
Discretionary	20.7	20.8	23.0	23.6	23.5	24.4	3.2	3.9
Mandatory	0.1	0.1	0.1	0.1	0.1	0.1	20.2	-4.2
Total	20.8	20.9	23.1	23.6	23.6	24.5	3.3	3.8

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 36 *Permanently Extend the Research and Experimentation Tax Credit*

250-1—Discretionary

Cut National Science Foundation Spending on Elementary and Secondary Education

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Spending							
Budget authority	-95	-96	-98	-100	-102	-491	-1,028
Outlays	-11	-49	-75	-90	-96	-321	-833

In 2006, the National Science Foundation (NSF) received $93 million to promote improved science and mathematics education in elementary and secondary schools. The NSF programs primarily support advanced teacher training and continuing education, but they also are used for development of instructional and assessment materials.

This option would eliminate funding for those efforts. Implementing this option would save $11 million in outlays in 2008 and $321 million over five years. (This option would not affect the Math and Science Partnership, which is included in the programs of the No Child Left Behind Act. NSF is a collaborator in that partnership, which complements the efforts of the Department of Education in meeting the act's goals for mathematics and science education.)

Proponents of this option argue that NSF's efforts duplicate the work of larger programs in the Department of Education and in state and local governments. The No Child Left Behind Act, for example, mandates the hiring of more highly qualified teachers in all fields (not just in science and mathematics), and it provides resources for developing teachers' skills. The act also requires school systems to undertake specific, systematic assessments of students' progress in reading, science, and mathematics in several grades. Currently, the Department of Education is spending $23 billion helping elementary and secondary schools to meet No Child Left Behind requirements, including those for science and mathematics achievement. In the 2002–2003 school year, state and local governments spent $400 billion on public elementary and secondary education, and many governments devote resources to improving the quality of training all their teachers receive, including their teachers of mathematics and science.

Opponents of this option argue that NSF leverages its small contribution by focusing on basic educational research while allowing other agencies to develop and implement programs that apply NSF's results. Thus, for example, NSF programs focus on providing professional resources for the instructors of science teachers, whereas the programs of the No Child Left Behind Act and the Math and Science Partnership implement quality improvement measures for the science teachers themselves. Furthermore, some note that current federal funding for teacher quality grants under the No Child Left Behind Act is inadequate.

250-2—Discretionary

End the Space Shuttle Program and Additional Assembly of the International Space Station

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-4,560	-5,240	-5,330	-5,430	-5,530	-26,090	-55,240
Outlays	-3,280	-5,070	-5,240	-5,370	-5,470	-24,430	-53,280

On February 1, 2003, the space shuttle *Columbia* was destroyed during its reentry to the Earth's atmosphere. On January 14, 2004, the National Aeronautics and Space Administration (NASA) unveiled the President's long-term Vision for Space Exploration, which stated that the remaining space shuttle fleet would return to flight to finish construction of the International Space Station (ISS) by about 2010. U.S. involvement in ISS operations would cease in 2017, and the U.S. research agenda before that time would be refocused to explore issues associated with long-duration human spaceflight. NASA originally estimated that 25–30 shuttle flights would be needed to complete ISS construction. The agency has since scaled back its plans for the ISS and now estimates 15 shuttle flights will be needed to complete that project.

Under this option, the shuttle program would be terminated immediately and the ISS would remain in its current configuration, saving NASA $3.3 billion in outlays in 2008 and $24 billion through 2012, relative to the Congressional Budget Office's baseline projections. Access to the ISS would continue to be provided by the Russian *Soyuz* spacecraft.

One rationale in favor of this option is that, even though the shuttle program is significantly smaller than earlier planned, it still may be difficult to complete 15 shuttle launches before 2011. To do so would require three to four launches each year through 2010, whereas NASA has been averaging one to two flights annually since 2005. In addition, there are continuing safety concerns involving foam shedding and the absence of the backup orbiter recommended by the Columbia Accident Investigation Board. Another argument in favor of this option is that even if the shuttle were used to finish construction of the ISS, the reduced scope of the scientific activities now planned means that little would be gained by completing the station's assembly.

An argument against this option is that its adoption would abrogate promises the United States has made to its international partners to complete ISS construction. The shuttle is essential to this task; the European, Russian, and Japanese modules yet to be added to the station have been designed and manufactured for transport by the space shuttle. In addition, retiring the shuttle in 2008 might preclude the Hubble servicing mission or force it to be accelerated to 2007. Finally, early retirement would hamper NASA's ability to sustain the engineering workforce needed to support human spaceflight, including the workers who now conduct launch operations at the Kennedy Space Center.

RELATED OPTION: 250-3

RELATED CBO PUBLICATIONS: *Alternatives for Future U.S. Space-Launch Capabilities,* October 2006; and *The Economic Effects of Federal Spending on Infrastructure and Other Investments,* June 1998

250-3—Discretionary

Delay NASA's Constellation Program by Five Years

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Spending							
Budget authority	-2,000	-2,330	-2,730	-6,010	-6,580	-19,650	-48,740
Outlays	-1,080	-2,060	-2,470	-4,440	-6,090	-16,140	-45,800

On January 14, 2004, the Bush Administration announced its Vision for Space Exploration (VSE), which provides guidance for the activities of the National Aeronautics and Space Administration (NASA). The VSE states that the space shuttle should be retired by 2010, that a new crew exploration vehicle (CEV) should replace the shuttle by 2014, and that CEV lunar missions should begin by 2020. The lunar missions will be a stepping-stone for human exploration of Mars and other more distant parts of the solar system. To return humans to the moon, NASA has decided to develop two launch vehicles: a crew launch vehicle (CLV), which will lift the CEV into orbit, and a larger and more powerful cargo launch vehicle (CaLV), for launching the hardware and fuel the CEV will require. Both of these new launch vehicles would incorporate some components of the existing space shuttle. Development of the CEV, CLV, and CaLV is being funded and managed under NASA's Constellation Program.

Under this option, the schedule for the Constellation Program would be extended by five years, delaying the first human lunar mission to 2025. However, research and technology development would continue unchanged, and an additional $500 million would be allotted annually to maintain the manufacturing and technology base. The resultant savings in outlays would be $1 billion in 2008 and would total about $16 billion through 2012.

A benefit of this option would be the additional time NASA would have to consider different approaches to conducting human lunar missions. During the past two years, NASA has made design changes to the CEV, CLV, and CaLV in response to technical concerns and budgetary constraints. Some observers argue that the shuttle-derived approach NASA has chosen is neither the least costly nor the safest approach, and they cite the design changes as supporting evidence. Others argue that the VSE's schedule constraints do not allow enough time to address the limitations that NASA's choices for the CLV and CaLV might impose on its ability to achieve long-term goals for exploring Mars and other more distant parts of the solar system. Delaying the first human lunar mission to 2025 would allow these issues to be studied in greater detail; it also would provide more time to implement whatever approach was chosen.

There are at least two drawbacks associated with this option, however. A delay of five years in developing and operating the CEV, CLV, and CaLV would extend to almost a decade the currently planned four-year hiatus in manned space missions and it would hamper the nation's ability to transport crew to the International Space Station. Such a delay also might adversely affect NASA's ability to sustain the engineering workforce needed to support human spaceflight, including the workers who now conduct launch operations at the Kennedy Space Center.

RELATED OPTION: 250-2

RELATED CBO PUBLICATIONS: *Alternatives for Future U.S. Space-Launch Capabilities,* October 2006; and *The Economic Effects of Federal Spending on Infrastructure and Other Investments,* June 1998

270

Energy

Energy research, production, conservation, and regulation make up the programs in function 270. The function includes the civilian programs in the Department of Energy (DOE): energy-related research and development; operation of the Strategic Petroleum Reserve (SPR); environmental cleanup of federal sites used for civilian energy research and production; development of a repository for nuclear waste at Yucca Mountain in Nevada; and energy conservation grants to states. The costs of regulating energy production and distribution also are included, but those expenses are offset almost entirely by fees charged to the regulated entities. Function 270 also covers federal agencies that generate and sell electricity, such as the Tennessee Valley Authority (an independent agency), and the four power marketing administrations managed by DOE. Loan programs to benefit rural electric and telephone cooperatives, managed by the Rural Utilities Service of the Department of Agriculture, also are included. (DOE's atomic weapons activities are found in budget function 050, national defense.)

Net outlays for function 270 are typically small—and in some years negative—because they include offsetting receipts from fees paid by the nation's nuclear utilities for future storage of nuclear waste; loan repayments to the Rural Utilities Service; and proceeds from the sale of SPR oil, uranium, and electricity. Excluding those receipts, spending for this function will total about $3.9 billion in 2007, the Congressional Budget Office estimates. That amount, although significantly lower than discretionary spending in much of the 1990s, is about 24 percent higher than average spending from 2002 to 2004. Since that time, spending has increased, primarily for energy research, conservation programs, environmental-cleanup expenses for DOE facilities, and other activities authorized under the Energy Policy Act of 2005.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	3.2	3.2	3.6	3.8	4.0	4.2	5.1	5.9
Outlays								
Discretionary	3.0	3.1	3.4	3.8	3.4	3.9	3.7	13.0
Mandatory	-2.5	-3.8	-3.6	-3.4	-2.7	-2.5	1.5	-5.8
Total	0.5	-0.7	-0.2	0.4	0.8	1.4	13.3	76.7

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 29 *Tax the Income Earned by Public Electric Power Utilities*

Revenue Option 55 *Extend the Gas-Guzzler Tax to Vehicles with a Gross Weight of 6,000 to 10,000 Pounds*

Revenue Option 56 *Eliminate Tax Credits for Producing Unconventional Fuels and Generating Electricity from Renewable Energy Resources*

270-1—Discretionary

Eliminate the Department of Energy's Applied Research for Fossil Fuels

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-594	-605	-618	-630	-643	-3,090	-6,509
Outlays	-149	-359	-515	-555	-596	-2,174	-5,495

The Department of Energy (DOE) received about $581 million in appropriations in 2006 to fund research into applied technologies for finding and producing petroleum, coal, and natural gas. Those research programs were created at a time when the prices of some fossil fuels were controlled, and as a result, market incentives for the development of technology were muted. Now that energy markets have been largely deregulated and are operating more freely, the value of federal spending for such research and development efforts may warrant reevaluation.

This option would eliminate DOE's applied research programs for fossil fuels, saving $149 million in outlays in 2008 and $2.2 billion over the next five years.

A rationale for ending such programs is that the pursuit of profits should give private suppliers sufficient incentive to develop better technologies and take them to market. Also, private entities are generally more attuned than federal officials are to which new technologies offer commercial promise. Federal programs have a history of funding fossil-fuel technologies that, although interesting technically, have limited practical value and, therefore, little chance of commercial implementation. A related rationale for eliminating the applied fossil-fuel research programs is that DOE could then concentrate on basic energy research that has broad public benefits—such as investigating new sources of energy—and reduce its involvement in developing commercially applicable technology. Arguably, the federal government has a clearer role to play in funding such basic research because the benefits are widespread rather than concentrated in individual companies.

In recent assessments of federal programs, the Office of Management and Budget (OMB) concluded that programs in many areas of fossil-fuel research, such as oil and natural gas technologies, duplicate private-sector spending. (For example, OMB's assessment of the oil-technology program stated: "Actual additional oil reserves attributable to technology developed by the program have been relatively small.") By contrast, OMB found that DOE's program to fund research into developing fuel cells for powering the electrical grid had a clear purpose, was free of design flaws, and served a national need. OMB rated the Coal Energy Technology Program "adequate."

A rationale against implementing the option can be found in assertions made by a panel of the National Academy of Sciences in 2001. The panel concluded that "DOE's RD&D [research, development, and demonstration] programs in fossil energy and energy efficiency have yielded significant benefits (economic, environmental, and national security-related), important technological options for potential application in a different (but possible) economic, political, and/or environmental setting, and important additions to the stock of engineering and scientific knowledge in a number of fields." The panel reported that although many of the earliest fossil-fuel programs (which emphasized synthetic fuels and other large-scale demonstrations) had produced below-average returns, projects since 1986 (which were more diverse and less focused on high-risk demonstrations) had yielded higher returns.

Another argument against this option is that DOE's efforts may help curtail the environmental damage resulting from the production and consumption of fossil fuels: By supporting applied research that enables those fuels to be used with less harm to the environment, their overall cost to society may be decreased. DOE's research programs may also increase energy efficiency and thereby lessen U.S. dependence on foreign oil.

RELATED OPTIONS: 270-2 and 270-7

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

270-2—Mandatory

Eliminate Funding for the Ultra-Deepwater and Unconventional Natural Gas and Other Petroleum Research Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-50	-50	-50	-50	-50	-250	-500
Outlays	-10	-30	-45	-50	-50	-185	-435

The Energy Policy Act of 2005 established the Ultra-Deepwater and Unconventional Natural Gas and Other Petroleum Research program under the Department of Energy (DOE) and directed DOE to begin program activities in 2007. Unlike most other DOE research programs, the ultra-deepwater program is funded by federal revenues from oil and gas leases rather than through annual appropriations.

Under this option, the program would be eliminated, saving $10 million in outlays in 2008 and $185 million over the 2008–2012 period.

Various rationales for implementing this option exist. In proposing to eliminate the program, the Administration argued that it would be more appropriate for the private sector to pay for the research and development (R&D) activities that would be supported by the program rather than for taxpayers to do so. Supporting that position is the general principle that the private parties who benefit from applied research ought to pay for it because they are better able than the public sector to decide how much to spend and on which specific projects. The government, by contrast, is in better position to pay for "basic" research, which produces fundamental knowledge that offers more widespread benefits and ensures that no single company captures the bulk of those benefits. Recent increases in the price of natural gas suggest that private investors have sufficient incentive to identify and develop new sources of natural gas. Moreover, the federal track record in funding other R&D related to natural gas exploration and production is not encouraging: The Office of Management and Budget recently noted that such federal efforts have made only a relatively small contribution to increasing the nation's natural gas reserves.

Another argument in favor of the option is the program's unusual funding mechanism: Funds are derived directly from federal oil and gas receipts rather than through annual appropriations. Such mandatory spending is not subject to the scrutiny of the appropriations process, and the merit of activities funded that way is not considered in the Congress's annual effort to allocate available discretionary funds.

A rationale against implementing the option is found in the legislation that created it. One goal of the program is to support small, independent producers, who do most of the actual drilling for oil and natural gas but cannot afford to develop the technology for drilling in ultra-deepwater on their own. Other arguments include the fact that such research might contribute to the safety of operations at natural gas production sites and to achieving various environmental goals, including the reduction of greenhouse-gas emissions and the sequestration of carbon already in the atmosphere. Federal support for research with possible environmental benefits is consistent with the idea that the cost of damage to the environment is not reflected in market prices for different primary sources of energy. Notwithstanding the current and projected levels of natural gas prices, producers may not have the incentives to undertake the amounts and types of R&D that would be desirable from society's point of view.

RELATED OPTION: 270-1

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

270-3—Discretionary

Eliminate the Department of Energy's Applied Research on Renewable Energy Sources

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-238	-242	-247	-252	-257	-1,236	-2,597
Outlays	-107	-204	-232	-248	-253	-1,044	-2,385

In 2006, the Department of Energy (DOE) received $312 million in appropriations to fund research and development (R&D) efforts focusing on solar power and other renewable sources of energy. The primary goals of those efforts were to develop alternative liquid fuels from plant materials (or biomass) and produce electricity from photovoltaic cells. To a lesser degree, funding was allotted for electric-energy storage and power from wind, hydro, and geothermal resources.

This option would eliminate federal funding for applied research on renewable energy, saving $107 million in outlays in 2008 and $1.0 billion through 2012. (The option excludes funding for hydrogen technology, which is included in Option 270-6.)

The principal rationale for this option is the belief that applied research into energy technologies is better left to the specific firms that will reap the benefits of such research. That argument acknowledges that the federal government can play an important role in funding basic scientific research: From society's point of view, market-driven R&D may fund too little basic research because private companies recognize that they may not reap the financial rewards of any resulting scientific discoveries. By extension, federally sponsored researchers typically lack the market incentives and information that guide researchers in private companies to recognize and develop marketable technologies.

Another argument for ending DOE's renewable-energy R&D programs is that many of the projects they fund are sufficiently small and discrete, and have a clear enough market, to attract private funding. Large rapidly growing commercial markets currently exist for several renewable-energy technologies—most notably, wind power and photovoltaic cells. According to industry estimates, the total U.S. capacity for electricity production from wind more than tripled between 2000 and 2005. The wind energy-generation market is even larger in the European Union, where it grew by 18 percent between 2004 and 2005. Similarly, the photovoltaic market, mainly outside the United States, has been expanding by more than 30 percent per year. In such cases, federal support may no longer be needed. Given the large U.S. venture-capital market, continued federal funding may be displacing private investment.

A further rationale for eliminating DOE's applied renewable-energy research is that other government efforts promote the same goals. For instance, the federal tax code provides incentives for the development of liquid fuels from renewable resources, especially biomass. (Ethanol fuels, for example, receive special treatment under the federal highway tax; see Revenue Option 49.) In addition, federal regulations authorized by many different statutes favor alcohol fuels, which now usually mean fuels derived from corn.

Several arguments, however, weigh against ending federal funding for renewable-energy research. First, incentives for private research may be insufficient because energy prices fail to reflect the national-security and environmental risks—including the potential for global warming—posed by the nation's continued dependence on fossil fuels. Second, the United States plays the role of international R&D laboratory for less-developed countries, which often have much higher energy costs. Third, a recent analysis by the National Academy of Sciences showed that many DOE-sponsored renewable-energy programs had met their technical goals to lower the costs and improve the performance of specific technologies. The fact that those technologies are not in widespread use results not from technical failures, according to the analysis, but from even larger decreases in the cost of

conventional energy and, to some extent, from institutional obstacles.

The Office of Management and Budget (OMB) reviewed some of DOE's renewable-energy initiatives as part of its assessment of federal programs and rated them "moderately effective" on the whole. In many instances, OMB said, program offices worked to ensure that the research they sponsored did not duplicate efforts by the private sector or other government programs. For example, although the geothermal energy program focuses on drilling methods, as does the oil industry, the geothermal environment is different enough (more difficult to access, subject to more extreme temperatures, and more challenging chemically) to require specialized technologies.

270

RELATED OPTIONS: 270-6 and Revenue Option 49

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

270-4—Discretionary

Eliminate Funding for Nuclear Energy Research and Development

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-158	-161	-164	-168	-171	-822	-1,726
Outlays	-71	-136	-154	-165	-169	-695	-1,587

Three applied nuclear energy research programs—the Advanced Fuel Cycle Initiative (AFCI), the Generation IV Nuclear Energy Systems Initiative, and the Nuclear Hydrogen Initiative (NHI)—seek to develop new ways to generate and harness nuclear energy while reducing radioactive waste and guarding against the potential for nuclear proliferation. The AFCI aims to develop a demonstration plant that would extract plutonium and other highly radioactive elements from spent nuclear fuel so as to provide proliferation-resistant recycled fuel for future reactors. The Generation IV initiative seeks to design six new types of reactors that would use fuel recycled by processes developed in the AFCI. (Those reactors would operate at very high temperatures, producing less waste than plants currently in operation and destroying some of the most radioactive and highest-temperature waste elements.) NHI would demonstrate that heat from Generation IV reactors can produce hydrogen fuel at a cost that is competitive with traditional fuel sources.

This option would eliminate funding for the AFCI, the Generation IV program, and the NHI. Such action would save $71 million in outlays in 2008 and $695 million through 2012. That estimate assumes that funding for these programs will remain at 2007 levels, adjusted for anticipated inflation.

One argument in favor of cutting those programs is that the federal government's funding of research should support basic science rather than applied projects because the former can have broader benefits to society as a whole. Firms that operate and build nuclear power plants, for example, would benefit most from technology developed under the AFCI, the Generation IV program, and the NHI without bearing the associated risks. Moreover, the private sector, which must answer to shareholders and creditors, is better situated than the government to judge the commercial viability of such projects. Further, a need for sustained federal support suggests that nuclear energy production might not compete successfully with other energy sources. And, the presence of more nuclear power plants would pose additional safety concerns and potential for contamination, with cleanup costs that could fall to the government. Finally, supporters of this option dispute the claim that the plutonium and transuranic elements extracted in the AFCI processes would inhibit proliferation.

A major rationale against this change is that, under the Atomic Energy Act of 1954, the federal government is responsible for managing nuclear waste. Long-term storage capacity for highly radioactive spent fuel is limited and difficult to obtain—for instance, the depository at Yucca Mountain in Nevada is not expected to accept waste before 2017, 19 years later than originally required by law. Opponents of implementing the option argue that the AFCI separation process would cut the amount of waste requiring such disposal and that Generation IV reactors would further reduce the amount of waste produced. The Nuclear Hydrogen Initiative, they observe, would make hydrogen a commercially viable alternative to fossil fuels. In addition, the public would benefit from reduced emissions of carbon dioxide, nitrogen oxide, sulfur dioxide, and other gases, as nuclear power generates none in producing electricity. They also contend that the technologies developed in those research programs would support the Global Nuclear Energy Partnership, which seeks to expand nuclear energy use overseas while limiting the potential diversion of nuclear materials for weapons uses. Lastly, federal funding of research to advance nuclear energy could be justified because the market might undervalue both the benefits of reduced amounts of safer nuclear waste and the potential environmental costs of carbon-emitting power sources.

RELATED OPTIONS: 270-5, 270-6, and 270-9

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

270-5—Discretionary

Eliminate Funding for the Department of Energy's Nuclear Power 2010 Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-66	-68	-69	-70	-72	-345	-724
Outlays	-30	-57	-65	-69	-71	-292	-666

The Nuclear Power 2010 program is designed to expand the electric generation capacity of nuclear power in the United States by reducing the private cost of plant design and the cost of licensing nuclear industry participants. No nuclear power plants have been ordered in the United States since 1978, despite the streamlining of the Nuclear Regulatory Commission's (NRC's) licensing process, which was mandated by the Energy Policy Act of 1992, and despite the fact that they generate electricity without emitting greenhouse gases. The Nuclear Power 2010 incentives are offered to the first few industry participants who attempt to license advanced nuclear power plants (plants using nuclear reactor designs that the NRC certified after December 31, 1993, none of which have been previously implemented in the United States). It is hoped that, by demonstrating the revised licensing process and advanced reactor designs, those projects may lead to the construction of advanced nuclear power plants that do not rely on subsidies.

This option would eliminate federal funding for the Nuclear Power 2010 program, which would reduce discretionary outlays by $30 million in 2008 and by $292 million over the 2008–2012 period. The estimate assumes that funding for the program will remain at 2007 levels, adjusted for anticipated inflation.

Supporters of the option argue that it is imprudent to provide public subsidies for projects whose risks and costs would otherwise be prohibitive to private firms. Sharing licensing costs may lead to nuclear industry participants' proposing projects that are excessively risky because the participants do not bear the entire cost of licensing failure. Advocates of canceling the program add that significant risks to public safety exist because of the vulnerability of nuclear plants to terrorist attacks and the potential for a catastrophic nuclear accident. They maintain that nuclear power plants damage the environment through routine radioactive discharges, the creation of long-lived radioactive waste, and the emission of greenhouse gases during plant construction and uranium mining (though not during operation). Another argument for eliminating subsidies for advanced nuclear power plants is that restrictions or taxes on greenhouse-gas emissions would more directly and efficiently reduce such emissions.

Opponents of eliminating the current program argue that only nuclear power plants are capable of generating large quantities of electricity at competitive costs without emitting greenhouse gases. They explain that although advanced nuclear power plants will become commercially viable, subsidies are initially necessary for three reasons: the relatively high regulatory risk facing the first few contractors to test the streamlined licensing process; the large construction costs anticipated for the initial implementation of each advanced reactor design; and the failure of U.S. electricity prices to account for the environmental cost of greenhouse-gas emissions under current regulations. Advocates of the program also note that the U.S. nuclear power industry has a better safety record than other major commercial energy technologies.

RELATED OPTIONS: 270-4 and 270-9

RELATED CBO PUBLICATION: *Evaluating the Role of Prices and R&D in Reducing Carbon Dioxide Emissions*, September 2006

270-6—Discretionary

Eliminate Funding for the Hydrogen Fuel Initiative, Including the FreedomCAR and Vehicle Technologies Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-237	-241	-246	-251	-256	-1,231	-2,568
Outlays	-107	-203	-231	-247	-252	-1,040	-2,375

In 2006, the Department of Energy received appropriations totaling $232 million for the Hydrogen Fuel Initiative. Federal funding for hydrogen fuel research aims to spur the development and use of hydrogen as a common source of stationary and vehicular power in the next few decades, thus reducing the nation's dependence on foreign oil. Such research addresses both fuel infrastructure—that is, the generation, delivery and storage of hydrogen—and those devices that might use hydrogen to produce energy. A key component of hydrogen fuel research is the FreedomCAR and Vehicle Technologies Program, a joint federal-private effort whose goal is to foster the development of energy-efficient vehicles by promoting research into fuel-cell technology. (Fuel cells generate electricity by stripping electrons from hydrogen fuel. When the electrons are recycled into the remaining fuel mixture and combined with oxygen, only water vapor is emitted.)

This option would end federal funding for the Hydrogen Fuel Initiative, including the FreedomCAR and Vehicle Technologies Program, saving $107 million in outlays in 2008 and $1 billion over five years.

Advocates of this option argue that hydrogen fuel research has been under way for some time in the private sector, that sufficient economic incentives to undertake such research already exist, and that government financial support does not induce greater private-sector efforts. They also point out that the results of a public-private partnership called the Partnership for a New Generation of Vehicles—which preceded FreedomCAR and was established to conduct advanced automotive research—were not encouraging. Specifically, that program lagged in its efforts to create a production-ready vehicle powered by a hybrid (diesel and electric) motor. Foreign car makers ended up being the first to supply the U.S. market with such vehicles.

A related argument is that the federal government should not spend research dollars to promote an infrastructure designed to support a fleet of fuel-cell automobiles because there are alternative ways to reduce the nation's dependence on imported oil. For example, instead of supporting applied research, the federal government could more effectively increase the efficiency of the nation's automotive fleet by raising gasoline taxes or by expanding and increasing fees on vehicles that get low gas mileage. Such action might also bring about more productive research by giving automakers greater incentive to identify and pursue a variety of vehicular technologies that may improve fuel efficiency (and potentially displace petroleum consumption altogether). Alternatives to fuel-cell technology that would power automobiles with relatively little or no use of petroleum include hybrid motors, purely electric motors, and engines powered by various fuel blends. Finally, although hydrogen-powered vehicles emit no pollutants, generating hydrogen fuel using current and foreseeable production technologies does pose significant environmental burdens.

Opponents of the option argue that, without government sponsorship, the private sector would underfund research in this area, for two reasons. First, private firms do not generally take into account the nation as a whole when considering the environmental or national-security benefits of energy-efficient technologies. Second, relative to other investment projects competing for private-sector dollars, the possibility of commercializing hydrogen fuel is far off and fraught with risk. Thus, opponents argue, federal funding is needed to raise the total amount of hydrogen fuel research to a level commensurate with its value to society.

RELATED OPTIONS: 270-4 and Revenue Options 48 and 55

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

270-7—Discretionary

Eliminate the Department of Energy's Applied Research on Energy-Conservation Technologies for Buildings

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-127	-129	-131	-134	-137	-658	-1,382
Outlays	-57	-109	-123	-132	-135	-556	-1,270

In 2006, the Department of Energy (DOE) received $124 million in appropriations for programs designed to develop energy-conserving technologies for commercial and residential buildings. (Other DOE programs related to energy conservation are discussed in Option 270-8.) Whether federal agencies should be involved in selecting and developing technologies with near-term commercial prospects, however, is the subject of some debate.

This option would eliminate DOE's applied research into energy-conservation technologies for buildings, saving $57 million in outlays in 2008 and $556 million over five years.

The major rationale for this option is that many projects funded through DOE's applied energy-conservation research are small enough and discrete enough—and have a sufficiently clear market—to warrant private investment. In such cases, DOE's efforts may deter private companies from pursuing similar initiatives. In other cases, the results of the research and development conducted by those programs may prove too expensive or esoteric for the intended recipients to implement. Moreover, those programs may duplicate support provided by other federal policies. (For example, federal law sets minimum energy-efficiency standards for appliances, and the tax code favors investments in conservation technologies.) This option illustrates the idea that the federal government should forgo developing applied energy technology, which benefits specific firms in the short run, and concentrate on basic research into the underlying science, which provides broader, longer-term benefits to the energy sector and to society as a whole.

A rationale against the option is expressed in conclusions reached by a panel of the National Academy of Sciences in 2001, which determined that "DOE's RD&D [research, development, and demonstration] programs in fossil energy and energy efficiency have yielded significant benefits (economic, environmental, and national security-related), important technological options for potential application in a different (but possible) economic, political, and/or environmental setting, and important additions to the stock of engineering and scientific knowledge in a number of fields." The panel further concluded that the energy-conservation research programs had particularly benefited the construction industry—a widely dispersed industry with no substantial record of technological innovation.

Another argument against eliminating those programs is that federal research and development in the area of energy conservation could help offset possible failures in energy markets. For example, current energy prices may not reflect damage to the environment—including the potential for global warming—caused by excessive reliance on fossil fuels. Energy conservation could decrease that damage (and thus the cumulative costs to society of producing and using energy) as well as the nation's dependence on foreign oil.

Recently, the Office of Management and Budget assessed some of DOE's applied energy-conservation research programs and rated them "adequate." The building-technology program was cited as coordinating well with private industry and other segments of the government to ensure that its work focused on technologies not yet ready for commercial application. It was also lauded for providing road maps of technological development for industry.

RELATED OPTIONS: 270-1 and 270-8

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

270-8—Discretionary

Eliminate the Department of Energy's State and Community Grants for Energy Conservation

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-37	-37	-38	-39	-40	-191	-401
Outlays	-17	-31	-36	-38	-39	-161	-367

The Department of Energy's (DOE's) Office of State and Community Programs provides grants that support energy-conservation efforts at the state and municipal levels. Weatherization-assistance grants help low-income households reduce their energy bills by installing insulation, storm windows, and weather stripping. Institutional-conservation grants help lessen energy use in educational and health care facilities, and help fund private-sector and municipal efforts to encourage local investment in building improvements. The Office of State and Community Programs also supports state and municipal programs that establish energy-efficiency standards for new and remodeled buildings and promote public transportation and carpooling, among other initiatives.

This option would eliminate funding for DOE's grant programs that support energy-conservation activities at the state and local levels. Ending those grant programs would save $17 million in outlays in 2008 and $161 million over the next five years.

One rationale for eliminating such energy-conservation grants is that other federal programs (for instance, the Low Income Home Energy Assistance Program block grants) promote similar conservation efforts. Moreover, direct federal funding may encourage state and local governments to forgo local funding for energy conservation and redirect their tax revenues to altogether different uses.

A rationale against the option is that ending DOE's grant programs could make it harder for states to continue their energy-conservation efforts. Many states rely heavily on such grants to assist low-income households and public institutions. In addition, reductions in energy use resulting from those programs could help lower emissions of greenhouse gases and other air pollutants.

RELATED OPTIONS: 270-7 and 300-10

270-9—Mandatory

Index the Nuclear Waste Fund Fee to Inflation

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-22	-42	-64	-86	-109	-323	-1,235

The Nuclear Waste Policy Act of 1982 authorized the Department of Energy (DOE) to build a long-term storage facility for high-level radioactive waste generated by civilian nuclear power plants and defense activities. Safely disposing of that waste (mainly spent uranium) requires isolating it for perpetuity at secure sites, far from population centers and commercially valuable property. In 1987, the Congress directed DOE to concentrate on the Yucca Mountain region of Nevada as the site for the waste-disposal facility. About 90 percent of the waste to be stored there is expected to come from civilian nuclear power plants. To fund the disposal of their radioactive waste, those plants are required to pay a fee of 0.1 cent per kilowatt-hour of electricity that they generate. Funds collected from that fee are allocated to the federal Nuclear Waste Fund. At the end of calendar year 2006, that fund held about $18.5 billion; another $6.6 billion had already been spent from the fund on site preparations and design.

This option would index the Nuclear Waste Fund fee to increase with inflation each year rather than remain fixed. That change would boost offsetting receipts (which are credited against direct spending) by $22 million in 2008 and by $323 million over the 2008–2012 period.

The Yucca Mountain facility was originally set to open in 1998, but that date was pushed forward to 2010. DOE now does not plan to start accepting radioactive waste at the site before 2017. Final construction of the storage facility awaits the establishment of safety standards by the Environmental Protection Agency and licensing by the Nuclear Regulatory Commission. DOE intends to file a license application with the Nuclear Regulatory Commission by the end of 2008. With delays in opening the repository, the nominal costs of construction and of annual operations continue to increase. Currently, the site is expected to cost a total of more than $57 billion—nearly twice the original estimate. The Administration has proposed legislation that, if acted upon and approved by the Congress, would affect project costs: That proposal is to repeal the statutory cap on the amount of waste that can be stored at the Yucca Mountain facility, reducing the scope of environmental review for the repository, and permanently withdrawing land around the mountain from public use.

Proponents of indexing the Nuclear Waste Fund fee to inflation note that the fee has not changed since 1983 even though estimates of the cost of the storage project have continued to rise. In addition, they say, the national threat of terrorism has increased the importance of the project—and the value of expediting its completion. Terrorist groups have shown an interest in attacking nuclear power plants, and such attacks could involve setting fire to the spent uranium that is stored at the plants (in facilities that are not as secure as Yucca Mountain would be). Also, expediting completion could reduce the risk that the federal government would be liable for reimbursing utilities for costs they incur to store commercial nuclear waste on an interim basis. (Reimbursements have already occurred in response to lawsuits that some utilities filed after the government missed the 1998 completion deadline established by the Nuclear Waste Policy Act.) Moreover, as currently designed, the Yucca Mountain facility would not be quite large enough to store all of the spent material—more than 70,000 metric tons—that civilian nuclear power plants are expected to be holding by 2017. (Those plants already store more than 50,000 metric tons of spent nuclear fuel.) Thus, higher fees may be needed to finance expansion of the Yucca Mountain facility beyond the capacity of its current design or to build a second, presumably more expensive, facility.

One argument against this option is that the Department of Energy generally maintains that the current fee would be sufficient to cover all of the expected costs of the Yucca Mountain facility. Another argument is that electricity producers should not have to pay higher fees to cover additional project costs resulting from delays caused by poor government management of the project. Some opponents go further and say that waste producers should not have to continue paying the fee at all, given large

uncertainties about whether the Yucca Mountain facility will ever be completed. The project faces technical challenges in the design of storage casks and in ensuring the geological integrity of the selected site (which some observers fear may not be impervious to water seepage or earthquakes). The project is also facing opposition because its location has become less remote since 1982 as a result of the rapid growth of nearby Las Vegas. Opponents also argue that storing spent nuclear material in many places around the United States may be safer than moving massive amounts of such material across the country to Yucca Mountain—through densely populated areas and on critical bridges and tunnels. In their view, it would be less expensive and more cost-effective to improve the storage security at power plants (using the amounts already collected for the Nuclear Waste Fund) than to proceed with the Yucca Mountain project.

270-10—Mandatory

Restructure the Power Marketing Administrations to Charge Higher Rates

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	-240	-250	-250	-260	-1,000	-2,390

The Department of Energy's three smallest power marketing administrations (PMAs)—the Western Area Power Administration, the Southwestern Power Administration, and the Southeastern Power Administration—provide about 1 percent of the nation's electricity. The PMAs generate electricity mainly from hydropower facilities constructed and operated by the Army Corps of Engineers and the Bureau of Reclamation. Current law requires that the electricity be sold at cost—a pricing structure intended ultimately to reimburse taxpayers for all of the costs of operating those facilities, a share of the costs of construction, and interest on the portion of total costs that has not been repaid. The financing terms for repaying the construction costs are generally favorable: For example, the interest rates used for older projects were set by statute, typically at levels below the government's then-current cost of borrowing. Those favorable financing terms and the low cost of generating electricity from hydropower mean that the PMAs can charge their customers much lower rates than other utilities do. Current law also requires the PMAs to offer their power first to rural electric cooperatives, municipal utilities, and other publicly owned utilities.

This option would require those three PMAs to sell electricity at market rates to any wholesale buyer. The higher rates would provide the federal government with about $1 billion in additional offsetting receipts (which are credited against direct spending) over the 2008–2012 period.

There are several arguments for discontinuing the subsidy for federal electricity sales. First, such subsidies are not needed to counter the market power of private utilities because those utilities are kept in check by federal and state regulation of the electricity supply, by federal antitrust laws, and increasingly by competition from independent producers. Second, in many cases, the communities that receive federal power are similar to neighboring communities that do not. Third, federal sales of electricity meet only a small share of the total power needs of households in the regions served by the three PMAs; thus, raising federal rates would have only a modest impact on those regions' economies. Fourth, the PMAs face the prospect of significant future costs to perform long-deferred maintenance and upgrades—costs that could be budgeted for by increasing power rates now. Fifth, when water levels are too low to generate sufficient hydropower, PMAs must purchase electricity from other wholesalers to fulfill the terms of their contracts with customers, even though purchased power is generally more expensive than hydropower and those contracts do not allow the PMAs to pass on the higher costs. Finally, selling electricity at below-market rates can encourage the inefficient use of energy.

A potential drawback of this option is that changing the pricing structure of those three PMAs could greatly increase electricity rates for some of the small and rural communities they serve. Other arguments against this change are that the federal government should continue providing low-cost power to counter the uncompetitive practices of investor-owned utilities and to bolster the economies of certain parts of the country.

RELATED OPTIONS: 270-11, 270-12, and Revenue Option 29

RELATED CBO PUBLICATION: *Should the Federal Government Sell Electricity?* November 1997

270-11—Mandatory

Sell the Southeastern Power Administration and Related Power-Generating Assets

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	-1,500	+150	+150	-1,200	-400

The Southeastern Power Administration (SEPA), which is administered by the Department of Energy, sells electricity from hydropower facilities constructed and operated by the Army Corps of Engineers. SEPA pays private transmission companies to deliver that power to nearly 500 wholesale customers, such as rural cooperatives, municipal utilities, other publicly owned utilities, and three investor-owned utilities. SEPA charges rates that are designed to recover for taxpayers all of the costs of current operations, some of the costs of construction, and a nominal interest charge on the portion of total costs that has not yet been recovered. On average, SEPA sells power for about 2.5 cents per kilowatt-hour, compared with more than 5.0 cents per kilowatt-hour for some utilities in that region.

This option would sell the power-generating assets that SEPA uses, such as turbines and generators owned by the Army Corps of Engineers, but not the related dams, reservoirs, or waterfront properties. The sale would also include rights of access to the water flows necessary for power generation, subject to the constraints of competing uses for the water. That sale would net the federal government $1.2 billion in offsetting receipts (which are credited against direct spending) over the 2008–2012 period: about $1.5 billion in proceeds from the sale (based on SEPA's most recent audited statement of its assets and liabilities) minus about $300 million in lost electricity revenues over that period. Proceeds could be higher or lower, depending on the terms of the sale. (In addition, the federal government would save about $47 million a year in discretionary outlays from ending appropriations to SEPA and reducing appropriations to the Corps of Engineers for operations. Those discretionary savings are not included in the table, above.)

Supporters of this option argue that selling federal power-generating assets is consistent with the policy goal of making energy markets more efficient. They say that the original reasons for establishing SEPA—marketing low-cost power to promote competition and foster economic development—are no longer compelling because of the small amount of power that SEPA sells and because of competitive and regulatory constraints on commercial power rates. Moreover, selling federal hydropower facilities would not mean transferring all responsibility for managing and protecting water resources to the private sector. The Corps of Engineers could remain directly responsible for managing water flows for all uses, including the upkeep of basic physical structures and surrounding properties. Or, as has happened with other nonfederal dams, the terms of the federal licenses to operate the facilities (issued by the Federal Energy Regulatory Commission) could determine the management of water flows for competing purposes.

An argument against ending federal ownership of SEPA is that nonfederal entities may lack the proper incentives to perform all of SEPA's functions. Many Corps of Engineers facilities serve multiple purposes, such as managing water resources for navigation, flood control, or recreation as well as for power generation. In addition, selling SEPA could result in higher power rates for its customers, depending on the terms of the sale. Although electricity sold by SEPA meets only about 1 percent of total power needs in the 11 states in which the agency operates, a few rural communities depend heavily on that electricity.

RELATED OPTIONS: 270-10, 270-12, and Revenue Option 29

RELATED CBO PUBLICATION: *Should the Federal Government Sell Electricity?* November 1997

270-12—Mandatory

Sell a Portion of the Tennessee Valley Authority's Electric Power Assets

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	+5	+5	+10	-16,000	+650	-15,330	-12,680

The Tennessee Valley Authority (TVA) was established in 1933 to control flooding, improve navigation, and develop the hydroelectric resources of the Tennessee River for the benefit of a seven-state region in the southeastern United States. Since that time, TVA has developed an extensive network of transmission facilities and nuclear- and fossil-fuel-powered generating plants and has become one of the largest producers of electricity in the nation. TVA is a federal agency, but it operates with many of the advantages of both public and private entities. For example, under current law, the agency controls its spending and rate setting, with no regulatory oversight. Also, TVA has ready access to capital because investors assume that its obligations would be paid off by the government in the event of default, even though current law states that its debt is not backed by the government. And, although the agency has a statutory cap of $30 billion on its bond debt, that cap no longer limits its liabilities because it has found ways to raise capital through various third-party-financing arrangements.

This option would return TVA to its original, more limited function of managing the region's hydropower resources. Other TVA power assets for which a commercial market exists—such as the agency's fossil-fuel and nuclear power plants and its transmission lines—would be sold. (The hydropower assets would be retained because they serve multiple purposes, such as flood control and recreation.) If, as is likely, proceeds were less than the amount of TVA's outstanding debt, taxpayers would probably have to bear some of the cost of servicing that debt (whatever portion that was not defrayed by future receipts from hydropower activities).

This option assumes that the sale of TVA's power-generation and -transmission assets would be completed by the end of 2011 and would raise about $16 billion. Proceeds could be higher or lower depending on the terms of the sale. That estimate is based on recent market transactions for electricity-generating facilities, adjusted for the likelihood that potential buyers would continue to serve customers under substantially the same terms as TVA for several years. The $16 billion estimated market value of TVA's assets is less than the agency's outstanding financial obligations—which currently total about $25 billion—in part because TVA invested some $6 billion in nuclear power plants that were never completed and also experienced significant cost overruns in the construction of other nuclear plants. Thus, some portion of TVA's debt would probably be retained by the government.

One rationale for this option is that the generation and transmission of electricity are fundamentally private-sector activities. In addition, this option would reduce the risk to taxpayers posed by TVA's plans to spend several billion dollars to build new nuclear power plants. Selling the agency's commercial power assets would also eliminate the implicit subsidy that TVA receives because its status as a federal agency earns it high bond ratings. Finally, private-sector operation of TVA's electric-power assets in a competitive environment could result in some increased efficiencies relative to those under federal operation.

An argument against the option is that the agency has played, and could continue to play, a central role in the economic development of its seven-state region. The net benefit to taxpayers from the sale is uncertain because it would depend on the price actually paid for the facilities, on the costs that TVA would otherwise incur if it continued to invest in power and transmission facilities, and on trends in electricity prices and markets. In addition, TVA's ratepayers could face higher electricity prices in the absence of federal subsidies.

RELATED OPTIONS: 270-10, 270-11, and Revenue Option 29

RELATED CBO PUBLICATION: *Should the Federal Government Sell Electricity?* November 1997

270-13—Mandatory

Reduce the Size of the Strategic Petroleum Reserve

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,500	0	0	0	0	-1,500	-1,500

The Strategic Petroleum Reserve (SPR)—a stock of government-owned crude oil stored at four underground sites along the Gulf of Mexico—was established to help insulate the United States against a severe disruption in oil supplies. Designed to hold about 727 million barrels of oil, the SPR is currently 95 percent full, just below its August 2005 peak of 96 percent. The Department of Energy (DOE) can draw oil from the SPR at a maximum sustained rate of 4.4 million barrels per day—or 44 percent of the United States' average daily oil imports and 21 percent of average daily U.S. petroleum consumption—for about 90 days (after that, the maximum draw rate declines). The Government Accountability Office estimates that, since 1976, the United States has spent about $45.2 billion (in 2005 dollars) to build, maintain, fill, and manage the SPR, including $35.1 billion to purchase oil. At a world price of $60 per barrel, the oil in the SPR was worth more than $41 billion as of early 2007.

Prior to the Gulf Coast hurricanes of 2005, the reserve contained 700 million barrels of oil. DOE sold 11 million barrels in response to those hurricanes and expects to replace that oil in 2007. DOE also plans to acquire the additional 27 million barrels needed to fill the SPR to capacity. In addition, the Administration recently proposed doubling the size of the SPR to 1.5 billion barrels by expanding capacity at existing sites and by building a new facility in Mississippi.

This option would require DOE to limit the size and capacity of the SPR to 700 million barrels, prohibiting the acquisition of the 27 million barrels of oil that DOE plans to add to the existing reserve. By limiting the amount of oil diverted to the SPR, this option would reduce outlays (by increasing offsetting receipts, which are credited against direct spending) by $1.5 billion in 2008.

DOE can acquire oil for the SPR through the Department of the Interior's (DOI's) royalty-in-kind program. DOI collects royalties from firms that produce oil and gas on federal lands, including the Outer Continental Shelf. The royalties are based on the amount the firms produce and are sometimes taken in-kind as oil and natural gas instead of cash. Current law authorizes DOE to take custody of in-kind oil for deposit into the SPR that DOI otherwise would sell (putting the proceeds into the Treasury). Diverting the oil into the SPR reduces offsetting receipts from DOI's royalty program by a corresponding amount. To date, the SPR has received, in nominal terms, about $4.3 billion worth of oil in lieu of royalty payments to the government.

Aside from the post-hurricane sale of 2005, DOE has sold oil from the SPR under emergency circumstances only once since it was established in 1975: Citing the risk of economically threatening oil-supply disruptions, more than 17 million barrels of oil were sold during the 1991 Gulf War. Oil has been released from the SPR for non-emergency purposes as well: A total of 5 million barrels was sold in test sales conducted in 1985 and 1990, and, as directed by lawmakers, a total of 28 million barrels was sold in 1996 and 1997 to reduce the federal deficit. On various occasions, a total of about 60 million barrels of oil has been released from the SPR to private firms and later replaced by exchange (with interest): In some cases, the release was in response to a temporary disruption in oil transport, such as a blocked pipeline; in other cases, the purpose was to exchange a particular grade of crude oil in the reserve for a higher quality of crude, or for heating oil (to establish an emergency reserve in the Northeastern United States). This option does not include budgetary savings that would be realized if reducing the size of the SPR led to a diminution of the exchange program and of losses associated with the program.

There are several rationales for limiting the size of the SPR, stemming from changes in the reserve's benefits and costs since 1975. Structural shifts in energy markets and in the U.S. economy at large have reduced the potential costs of a disruption in oil supplies and, consequently, any potential benefits that might arise from releasing oil in a crisis. In particular, the increasing diversity of world

oil supplies and the growing integration of the economies of oil-producing and oil-consuming nations have lessened the risk of a sustained, widespread disruption. In addition, the cost of maintaining the SPR has risen because many of the reserve's facilities are aging, requiring unanticipated spending for repairs. Moreover, the government's ability to smooth oil prices through SPR purchases and releases may be limited. For example, DOE's experience with selling oil during the Gulf War and more recently indicates that the process of deciding to release oil and setting prices can itself add to market uncertainty.

There are also several arguments against reducing the current level of strategic petroleum reserves. One contention is that with continued growth in the demand for oil, the United States eventually would be unable to maintain the equivalent of 90 days of net oil imports in reserves of oil or petroleum products (including private stocks) without expanding the SPR. (The United States and other nations have committed to the International Energy Agency to maintain reserves at least at that level.) Consistent with that viewpoint, DOE has proposed expanding the capacity of the SPR to a total of 1.5 billion barrels. Another argument against limiting SPR capacity is that oil supplies from the Persian Gulf and other regions continue to be unstable. U.S. reliance on imported crude oil—particularly from the Middle East—is expected to keep growing, and the probability of terrorist attacks on the oil system may be significant; thus, the benefits of programs, such as the SPR, that are designed to guard against supply disruptions may be growing as well. Finally, in an assessment of federal programs, the Office of Management and Budget in 2005 rated the SPR program "effective" because it considered the program to be well-designed, to have a clear mission, and to make a unique contribution in providing an emergency oil-supply inventory.

RELATED CBO PUBLICATIONS: *The Economic Effects of Recent Increases in Energy Prices*, July 2006; and *Rethinking Emergency Energy Policy*, December 1994

300

Natural Resources and Environment

Budget function 300 encompasses programs administered by the Department of the Interior, the Department of Agriculture, and the Army Corps of Engineers for land and water management, resource conservation, recreation, wildlife management, and mineral development. This function also covers funding for the National Oceanic and Atmospheric Administration, which administers ocean and fisheries programs, and the Environmental Protection Agency, which administers the Superfund, makes grants to states, and issues and enforces environmental regulations.

On average, appropriations for discretionary programs rose by very little (just 2.5 percent annually) between 2002 and 2005. However, in 2006, discretionary funding jumped by 19 percent because of supplemental appropriations for post-hurricane rebuilding efforts along the Gulf Coast. Most of that additional funding ($7 billion) was provided to the Army Corps of Engineers. Discretionary funding for 2007 totals $30 billion, a decline of about 20 percent from the previous year, CBO estimates, and lower than the appropriations in 2004 and 2005.

Mandatory spending in this function is mostly for farm conservation programs authorized by the Farm Security and Rural Investment Act of 2002, which provides $3.8 billion in 2007 for cost-sharing assistance; annual rental payments; and long-term easements to help agricultural producers protect soil, water, and wildlife habitat. The spending in this function is partially offset by receipts from the sale of minerals, timber, and land; recreation fees; and other charges to users, which total about $6 billion in 2007, the Congressional Budget Office estimates.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	29.6	30.1	31.1	31.9	38.1	30.4	6.5	-20.3
Outlays								
Discretionary	28.6	30.3	30.6	30.3	34.0	31.9	4.4	-6.2
Mandatory	0.8	-0.6	0.1	-2.3	-0.9	1.0	n.a.	n.a.
Total	29.5	29.7	30.7	28.0	33.1	32.9	3.0	-0.7

Note: n.a. = not applicable (because of a negative value in the first or last year).

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 28 *Repeal the Expensing of Exploration and Development Costs for Extractive Industries*

Revenue Option 51 *Impose a Tax on Sulfur Dioxide Emissions*

Revenue Option 52 *Impose a Tax on Nitrogen Oxide Emissions*

Revenue Option 53 *Impose an "Upstream" Tax on Carbon Emissions*

Revenue Option 54 *Reinstate the Superfund Taxes*

Revenue Option 58 *Impose Fees That Recover the Environmental Protection Agency's Costs Related to Pesticides and New Chemicals*

300-1—Discretionary or Mandatory

Increase Fees for Permits Issued by the Army Corps of Engineers

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-13	-25	-27	-28	-29	-122	-280

Note: This fee could be classified as an offsetting collection (discretionary) or as an offsetting receipt (usually mandatory), depending on the specific language of the legislation establishing the fee.

The Army Corps of Engineers administers laws that pertain to the regulation of the nation's navigable waters. Section 10 of the Rivers and Harbors Act of 1890 requires the Corps to issue permits for work that would affect the navigable capacity of any waters of the United States. In addition, section 404 of the Clean Water Act of 1977 requires the Corps to issue permits for dredging or placing fill material in navigable waters. In 2005, the Corps received about 92,000 permit applications, some of which require more detailed review than others. Currently, companies that apply for commercial permits pay a fee of $100, and people who apply for private permits pay $10. (Government applicants are not charged a fee.) That fee structure, which has not changed since 1977, covers only about 5 percent of the costs of administering the program.

This option would raise the fee for commercial permits issued under sections 10 and 404 by an amount sufficient to recover the costs associated with awarding those permits. (The fee for private permits would not change.) That increase would reduce federal outlays by $13 million in 2008 and by $122 million over the 2008–2012 period.

Section 404 has become the core of the nation's effort to protect wetlands. It has been applied to waters that would not conventionally seem "navigable," such as wetlands adjacent to navigable waters and, under certain circumstances, wetlands adjacent to nonnavigable tributaries of waters traditionally considered navigable. Thus, the Corps has regulatory jurisdiction over a large number of wetlands. (Consistent with a 2006 Supreme Court decision, the extent of that jurisdiction ultimately will be determined by federal agencies' interpretations of certain terms and definitions—such as "relatively permanent" and "intermittent" flow and what constitutes a "significant nexus" to navigable waters—and whether those interpretations withstand the scrutiny of the courts.) Moreover, for the purposes of section 404, "dredging" and "placing fill material" encompass virtually any activity in which dirt is moved, which means that a wide variety of actions require permits.

Under section 404, the Corps must evaluate each application and grant or deny a permit on the basis of expert opinion and statutory guidelines. Most applications are quickly approved through existing general or regional permits, which grant authority for many low-impact activities. Evaluation of applications not covered by existing permits may require the Corps to undertake more-detailed, lengthier—and therefore more-costly—reviews.

The principal rationale for imposing cost-of-service fees on commercial applicants is that the party pursuing a permit, not the taxpaying public, should bear the cost of such permits. According to that argument, taxpayers should not have to pay for something that advances a commercial interest whose benefits accrue to a comparative few.

An argument against higher fees is that permit seekers should not have to pay more for a process that ultimately might deny them the right to use their land as they wish. The goal of the section 404 program, for example, is to advance a public interest by protecting wetlands. Arguably, since the public benefits from wetlands protection (sometimes at the expense of property owners), it should bear the costs. Critics maintain that the regulatory process that property owners must deal with is already onerous, so raising permit fees would further infringe on property owners' rights.

RELATED CBO PUBLICATION: *Regulatory Takings and Proposals for Change*, December 1998

300-2—Discretionary

Eliminate Federal Funding for Beach-Replenishment Projects

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-100	-103	-105	-107	-109	-524	-1,106
Outlays	-28	-86	-103	-106	-108	-431	-1,006

The Army Corps of Engineers conducts various operations designed to counter beach erosion, typically by dredging sand from offshore locations and pumping it onshore to rebuild eroded areas. The Corps funds a portion of such activities, and state and local governments pay the rest. Those operations have two primary goals: mitigating damage (replenishment helps beaches act as barriers to waves and protects coastal property from severe weather) and enhancing recreation.

This option would end federal funding for beach-replenishment activities. Doing so would reduce discretionary outlays by $28 million in 2008 and by $431 million through 2012.

Proponents of halting federal spending for beach replenishment argue that its benefits accrue largely to the states and localities in which the projects occur and that the cost should therefore be borne entirely at the state and local level. Furthermore, the ultimate effectiveness of replenishment efforts is questionable. Beach erosion is a natural process, and replenishment projects serve only to temporarily delay the inevitable natural shifting of beaches. One alternative to beach-replenishment projects is to remove the various retention structures that sometimes exacerbate erosion by inhibiting the natural flow of sand along a beach.

Opponents of eliminating federal funding argue that beach replenishment not only benefits specific states and localities but also serves the interests of nonresident beachgoers. Opponents also argue that, in some cases, federal projects (such as those intended to keep coastal inlets open) contribute to beach erosion, so federal taxpayers should bear some of the cost of replenishment in those areas. Moreover, ending federal funding could be considered unfair if municipalities and private owners invested in beachfront property with the expectation of continuing federal support.

300-3—Mandatory

Revise and Reauthorize the Bureau of Land Management's Land Sales Process

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-28	-32	-32	-35	-35	-162	-337
Outlays	-1	-12	-23	-72	-65	-173	-364

Under the Federal Land Transaction Facilitation Act of 2000 (FLTFA), the Bureau of Land Management (BLM) is authorized to use proceeds from the sale of previously designated public lands to fund the acquisition of other, qualifying parcels of land and to cover expenses associated with those transactions. That act expires after 2010. According to the Administration, FLTFA was enacted to encourage the sale of lands that contribute little to BLM's mission and to purchase other parcels of land more in keeping with that mission, including those featuring "exceptional resources." Before FLTFA, proceeds from BLM land sales went directly to the Treasury, under the Federal Land Policy and Management Act.

This option, which is also included in the Administration's proposed budget for 2008, would amend FLTFA to expand the set of lands that the Department of the Interior would be authorized to sell, alter the distribution of proceeds from such sales, and extend the act beyond 2010. Instead of designating that all proceeds from such land sales be used to acquire other parcels of land and to cover sales expenses, the option would direct 70 percent of the first $60 million per year in proceeds, net of BLM's administrative costs, to the Treasury, along with all proceeds over $60 million each year. (The remainder of the proceeds would go to the Department of the Interior for land acquisition and restoration projects on BLM land.) The option also would allow lands to be sold according to updated resource management plans rather than limiting such sales only to parcels classified prior to July 25, 2000, when FLTFA was enacted. The option would reduce direct spending by $1 million in 2008 and by $173 million from 2008 to 2012.

Supporters of this option contend that it would minimize the amount of Federal spending that is not subject to regular oversight through the Congressional appropriation process. They argue that the change would reduce the federal budget deficit and would ensure that U.S. taxpayers benefited directly from land sales. Supporters also say that expanding the set of lands that the Department of the Interior would be authorized to sell would give BLM greater flexibility, enhancing its ability to consolidate its land holdings into larger areas that are less scattered and that can be more efficiently managed.

Opponents of this option say that it is not consistent with the policy of retaining lands in public ownership, as set forth in 1976 in the Federal Land Policy and Management Act. They say that FLTFA was intended to provide the Department of the Interior with a source of revenue to supplement the Land and Water Conservation Fund for acquiring high-priority private lands for inclusion in National Parks, National Forests, and BLM conservation areas. Opponents also maintain that the option would implicitly or explicitly place land managers under pressure to sell tracts of land to meet revenue expectations.

300-4—Discretionary and Mandatory

Reduce Funding for Timber Sales That Lose Money

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Net Change in Spending							
Budget authority	-55	-57	-59	-61	-63	-295	-641
Outlays	-45	-55	-58	-60	-62	-280	-623

The Forest Service manages federal timber sales from national forests. According to annual reports by the agency's Forest Management Program, the service has spent more on the timber program in recent years than it has collected from companies that harvest the timber. In 2006, for example, when it sold roughly 2.8 billion board feet of public timber, funding reported for the program exceeded collections by about $75 million.

This option would eliminate discretionary funding for all future timber sales in four regions of the National Forest System—the Southwestern, Intermountain, Pacific Southwest, and Alaska regions—where expenditures in recent years were more than twice as high as offsetting receipts. Ending those sales would reduce the Forest Service's net outlays by $45 million in 2008 and by $280 million over the 2008–2012 period. (Those estimates are net of the income losses from eliminating sales in those regions.) The Forest Service does not maintain the necessary data to estimate the annual income and expenditures associated with individual timber sales. Thus, it is difficult to precisely estimate the budgetary savings that might arise from phasing out all timber sales in the National Forest System for which expenditures are likely to exceed offsetting receipts. This option focuses on the four regions listed to illustrate possible savings.

An argument in favor of ending timber sales in those regions is that federal taxpayers should not have to subsidize the profit-making activities of private companies. Other arguments are that such sales may lead to excessive depletion of federal timber resources and to the destruction of roadless forests that have recreational value.

An argument against ending the sales is that they might help bring stability to communities dependent on federal timber for logging and related jobs. Also, as a result of road construction, timber sales might foster access to forested land, enhancing firefighting efforts and expanding recreational uses.

RELATED OPTIONS: 300-5, 300-6, and 300-7

300-5—Discretionary or Mandatory

Reauthorize Maintenance and Location Fees and Charge Royalties for Hardrock Mining on Federal Lands

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-8	-47	-42	-38	-35	-170	-305

Note: Maintenance and location fees could be classified as discretionary offsetting collections (as they are now) or as mandatory offsetting receipts, depending on the specific language of the legislation reauthorizing them. Royalties would be treated as offsetting receipts.

The General Mining Law of 1872, originally intended to encourage settlement of the American West, governs access to hardrock minerals—such as copper, gold, silver, and uranium—on public lands. Unlike extractors of other minerals or fossil fuels from public lands, miners do not pay royalties to the government on the value of hardrock minerals that they remove. Instead, under the mining law, holders of more than 10 mining claims on public lands pay an annual maintenance fee of $125 per claim. Holders also pay a one-time $32 location fee when recording a claim. Authorization for the federal government to collect the maintenance and location fees expires in 2008.

The gross value of hardrock mineral production on public lands totals about $1 billion a year, according to current estimates. That value has risen in recent years largely because of increased demand, particularly in developing countries, for industrial commodities such as copper and molybdenum.

This option would reauthorize currently existing maintenance and location fees. It also would halt new patenting of public lands. In patenting, miners gain full title to public lands by paying a one-time fee of $2.50 per acre for placer claims (which allow the mining of alluvial deposits in modern or ancient stream beds) or $5 per acre for lode claims (which permit the extraction of mineral deposits from solid rock). Further, mirroring proposals that the Congress has considered in the past, it would impose an 8 percent royalty on all future production of hardrock minerals from those lands. The royalty would apply to net proceeds—defined as revenues from sales minus costs for mining, separation, transportation, and other activities. Together, those changes would increase federal collections by $170 million over five years: $135 million from reauthorization of maintenance and location fees and $35 million from royalty payments. (If the 8 percent royalty was applied to gross proceeds rather than to net proceeds, it would raise more money and be less costly to administer.)

The Congressional Budget Office's estimates assume that the states in which mining takes place would receive 10 percent of the royalty receipts. The estimates also assume that there would be no surge in patenting activity before royalties were imposed; such a surge could boost immediate patenting receipts and diminish future royalties.

Supporters of this option—including many environmental advocates—argue that low maintenance fees and the lack of royalties make mineral production less costly on federal lands than on private lands (where the payment of royalties is the rule). That difference, they contend, encourages overdevelopment of public lands, which may cause extensive environmental damage. Changing that situation could promote other uses for those lands, such as recreation or wilderness conservation.

An argument against ending patenting and imposing royalties is that, without free access to public resources, miners (especially small-scale miners) would limit their exploration for hardrock minerals in the United States. In addition, royalties could diminish the profitability of many mines, leading to scaled-back operations or closure and adverse economic consequences for mining communities in the West. Because the prices of many minerals are set in world markets, miners would be unable to pass their new royalty costs on to buyers.

RELATED OPTIONS: 300-4, 300-6, 300-7, and Revenue Option 28

RELATED CBO PUBLICATION: *Reforming the Federal Royalty Program for Oil and Gas*, November 2000

300-6—Discretionary or Mandatory

Use State Formulas to Set Grazing Fees for Federal Lands

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-13	-23	-28	-31	-30	-125	-141

Note: This fee could be classified as an offsetting collection (discretionary) or as an offsetting receipt (usually mandatory), depending on the specific language of the legislation establishing the fee.

The federal government owns and manages more than 650 million acres of public lands, which have many uses, including the provision of grazing for privately owned livestock. The Forest Service and the Bureau of Land Management administer grazing on some 155 million acres of public lands in the West. Ranchers are authorized to use that acreage for almost 20 million animal unit months (AUMs)—a standard measure that reflects the amount of forage needed by a cow and a calf for one month. As of March 1, 2007, cattle owners who have permits that allow their animals to graze on federal lands in the West will have to pay the government a fee of $1.35 per AUM. However, that fee may not give the public a fair return.

This option would set grazing fees for federal lands in each state in the same way that the state determines such fees on state-owned lands. If the federal government implemented this option over 10 years as existing grazing permits expired, the fee would rise almost 10-fold, on average. That increase would boost net federal collections by $13 million in 2008 and by a total of $125 million through 2012. (Under current law, the governments of those states and counties in which grazing takes place receive a portion of the federal fees. The estimates shown here are net of additional payments to states and counties, which would total roughly $41 million over the 2008–2012 period. The estimates do not reflect any additional appropriations for range improvements that could result from the added collections. However, they do incorporate an assumption about the extent to which an increase in fees might cause ranchers to reduce their use of AUMs.)

The current formula for federal grazing fees was established in the Public Rangelands Improvement Act of 1978. The formula uses a 1966 base value of $1.23 per AUM and adjusts it to account for changes in the market for beef cattle as well as in the markets for feed, fuel, and other production inputs. Over the years, the Congress has considered various proposals to increase grazing fees.

The principal justification for an increase is that the current formula appears to result in fees that are well below market rates and also below the federal costs of administering the grazing program. For example, in 1990, the appraised value of public rangelands in six Western states varied between $5 and $10 per AUM, far above the $1.81 fee charged that year. In addition, a 2005 study indicated that the Forest Service and the Bureau of Land Management would have had to charge $12.26 and $7.64, respectively, per AUM to cover their expenditures for managing their grazing programs in 2004, although the fee that year was $1.43 per AUM. Critics charge that such low fees subsidize ranching and contribute to overgrazing and deteriorating range conditions.

A rationale for using state formulas to set federal fees is that such an approach rejects the uniform nature of the current formula and instead follows decisions made at the state level. Grazing fees and methods for calculating them vary widely from state to state and sometimes even within a state. States' interest in the revenue received from both state and federal fees would lessen any incentive to manipulate state fees to lower federal fees.

An argument against this option is that state rangelands may be more valuable than federal lands for grazing purposes. Some formulas that states use to set fees might not reflect those differences in quality and conditions of use if applied to federal lands. In addition, using different procedures to set federal grazing fees in each state would result in higher administrative costs than those incurred under the current uniform federal formula. (The estimates for this option do not take into account possible increases in administrative costs.)

RELATED OPTIONS: 300-4, 300-5, and 300-7

300-7—Mandatory

Open the Coastal Plain of the Arctic National Wildlife Refuge to Leasing

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	-2,500	-2	-500	-3,002	-3,089

The Arctic National Wildlife Refuge (ANWR) consists of 19 million acres in northeastern Alaska; 1.5 million of that acreage consists of coastal plain, the least disturbed coastal region in the Arctic. ANWR was established to conserve fish and wildlife habitats, fulfill international treaty obligations related to wildlife and habitat protection, provide opportunities for indigenous people to continue their traditional lifestyles, and protect water quality. The Alaska National Interest Lands Conservation Act of 1980, which set up the reserve, prohibits industrial activity on ANWR's coastal plain unless specifically authorized by the Congress. According to the U.S. Geological Survey, that plain appears to have the most promising potential for oil production of any unexplored onshore area in the United States.

This option would open ANWR's coastal plain to the production of oil and natural gas. The Congressional Budget Office, following recent legislative proposals, assumes that leases would be offered in two phases, with the first sale likely to occur in 2010 and the second in 2012. With the federal government receiving proceeds from auctioning leases for oil and gas development rights, this option would raise about $6 billion over the 2008–2012 period. (Although the federal government would later receive income from royalties on production, the bulk of those payments would occur after 2017.) Under recent legislative proposals, half of those funds would go to the state of Alaska, leaving $3 billion in net offsetting receipts (which are credited against direct spending) to the federal government over the 2008–2012 period.

CBO's estimate is based on the U.S. Geological Survey's projections of the mean value of economically recoverable oil that could be produced from federal land in ANWR. It also relies on information from other federal agencies, the state of Alaska, and industry experts about oil and gas companies' perceptions of key factors that affect the expected profitability of ANWR leases—in particular, companies' probable assumptions about long-term oil prices, volumes of recoverable reserves, and required rates of return on such investments.

Proponents of this option highlight the national security advantages of reducing U.S. dependence on imported oil. They argue that most of ANWR would remain closed to development and that the section of the coastal plain that would be directly affected by oil drilling and production represents less than 1 percent of the entire refuge area. Moreover, they maintain, technological changes have improved the ability of the oil and gas industries to safeguard the environment.

Opponents of this option argue that whatever the still-uncertain gain from oil production in ANWR, extracting a nonrenewable resource for a relatively short time will not provide lasting energy security. In addition, they say, ANWR's coastal plain is a crucial area for the biological productivity of the refuge, and industrial activity there would pose a threat to wildlife and the environment, despite efforts to mitigate its impact. Moreover, such activity could affect international treaty obligations.

RELATED OPTIONS: 300-4, 300-5, and 300-6

300-8—Mandatory

Reassign Reimbursable Costs for Water Projects Not Serving All Planned Beneficiaries

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	-27	-27	-27	-27	-108	-243

For more than a century, the federal government, through the Bureau of Reclamation, has helped finance and build infrastructure to support municipal and industrial water supplies, hydroelectric power generation, irrigation, flood control, and recreational usage. Under current law, users of water for agricultural, municipal, and industrial purposes, as well as users of hydropower generated by federal water projects, must make payments intended to recover some of the government's construction costs. For those who use water for hydropower and municipal and industrial purposes, reimbursement includes making interest payments. That requirement does not extend to irrigators. Moreover, a determination by the Secretary of the Interior that irrigators' repayment obligations exceed their ability to pay shifts the associated reimbursement responsibilities to users of hydropower.

As originally authorized in 1944, a portion of the Pick-Sloan Missouri Basin Program's power facilities and reservoirs was intended to support regional irrigation facilities. Agricultural users were to reimburse the federal government for that portion, without interest, upon completion of the irrigation facilities. Although the program's power facilities and reservoirs have been largely completed, only some of the planned irrigation facilities have been constructed. The Bureau of Reclamation maintains that the benefits of constructing the remaining irrigation facilities do not justify the costs. As those facilities are unlikely to be built, the federal government cannot charge the intended users for their share of the federal government's original investment in the power facilities and reservoirs that have been completed.

This option would make power customers who use the existing facilities responsible for that portion of the reimbursement originally assigned to irrigators on the basis of plans for facilities that were not realized. Reassigning those reimbursement responsibilities would increase offsetting receipts (which are credited against direct spending) by $108 million through 2012.

Proponents of this option argue that power customers receive subsidized service because they benefit from, but do not pay for, the extra capacity that was built into the facilities to support irrigation. Another argument for the change is that if the federal government's overall investment in other aspects of the completed hydropower facilities increased (because of renovation and replacements) the amount of the investment that is unrecoverable also might increase.

Opponents of this option argue that power customers are already responsible for repaying the majority of the project's irrigation-related investment because of ability-to-pay determinations. They also maintain that the irrigation facilities that have not been constructed are still Congressionally authorized projects that could be funded in the future.

RELATED CBO PUBLICATION: *How Federal Policies Affect the Allocation of Water*, August 2006

300-9—Discretionary

Eliminate Federal Grants for Wastewater and Drinking Water Infrastructure

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-640	-977	-1,659	-1,689	-1,719	-6,685	-15,755
Outlays	-32	-145	-422	-819	-1,226	-2,644	-10,808

Two major laws administered by the Environmental Protection Agency (EPA)—the Clean Water Act (CWA) and the Safe Drinking Water Act (SDWA)—seek to protect the quality of the nation's waters and the safety of its drinking water supply by requiring municipal wastewater and drinking water systems to meet certain performance standards. Both laws provide for grants to capitalize revolving funds at the state level. States use the revolving funds to offer various forms of assistance (such as market-rate and subsidized loans, loan or bond guarantees, and bond purchases) to communities to help them build or replace systems to meet the federal standards. For 2006, EPA received total appropriations of about $2 billion for water-infrastructure grants, including $900 million for clean water funds, $850 million for drinking water funds, and roughly $300 million for targeted grants to specific communities.

This option would phase out all of EPA's grant funding for wastewater and drinking water facilities over a transitional period of three years. Such action would reduce federal outlays by $32 million in 2008 and by $2.6 billion through 2012.

Amendments to the CWA in 1987 phased out a previous program that provided direct grants for the construction of wastewater treatment facilities and replaced it with the program to support wastewater systems through new state revolving funds (known as SRFs). Under that program, states contribute matching funds of 20 cents per federal dollar and operate their SRFs within broad limits, defining eligible projects (which may focus not only on treatment facilities but also on the installation, rehabilitation, or replacement of sewer pipes, control of urban and agricultural runoff, and other water-quality efforts), choosing the terms of the assistance, and setting priorities. In 2005, 67 percent of the loans made by SRFs—representing 22 percent of the total funding—went to communities with populations under 10,000. Authorization for the SRF program under the Clean Water Act has expired, but the Congress continues to provide annual appropriations for grants, distributing them to the states according to the shares specified in the 1987 amendments.

Amendments to the SDWA in 1996 authorized EPA to make grants to capitalize state revolving-loan funds for drinking water systems. Although generally modeled on the CWA's wastewater program, the drinking water program allocates federal funding according to a formula based on needs identified in a quadrennial EPA survey. In turn, states are required to establish a priority-setting system that focuses on the most serious health risks associated with drinking water, compliance with SDWA quality standards, and the financial needs of local water systems.

One justification for eliminating federal grants to water-related SRFs is that such grants could encourage inefficient decisions about water infrastructure by allowing states to lend money at below-market interest rates, which in turn could reduce incentives for local governments to find less-costly ways to control water pollution and provide safe drinking water. Another rationale is that federal contributions to wastewater SRFs originally were viewed as a temporary step on the way to full state and local financing. Moreover, those contributions might not increase total investment in water systems if they merely replace funding that state and local sources would have provided otherwise.

Opponents of such cuts argue that the need for investments to replace aging infrastructure, reduce health threats in drinking water (such as from cryptosporidium), and protect the nation's waters (from sewer overflows, for example) is so large that federal aid should be increased, not reduced. Without external assistance, they say, water systems in many small or economically disadvantaged

communities would be unable to maintain the quality of their service and comply with the CWA's and SDWA's new and forthcoming requirements. States, they contend, cannot supply all of the necessary funding. Opponents of the option also argue that eliminating the federal grants would force even many large systems—which tend to have lower costs because of economies of scale—to charge rates that would pose significant hardships for low- and moderate-income households. Moreover, they note that the most recent assessments of the grant programs by the Office of Management and Budget concluded that both are performing adequately and appear to be making progress toward their long-term goals.

RELATED OPTION: 450-4

RELATED CBO PUBLICATIONS: *Letter to the Honorable Don Young and James L. Oberstar regarding future spending on water infrastructure*, January 31, 2003; *Future Investment in Drinking Water and Wastewater Infrastructure*, November 2002; and *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

300-10—Discretionary

Eliminate the Environmental Protection Agency's Energy Star Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2015
Change in Spending							
Budget authority	-53	-54	-56	-57	-58	-278	-587
Outlays	-45	-53	-55	-57	-58	-268	-576

Energy Star is a product-labeling and certification program run by the Environmental Protection Agency (EPA). Its goal is to help consumers and organizations save energy and reduce greenhouse-gas emissions by choosing products or management practices that are energy efficient or that rely on clean forms of energy. EPA allows businesses, institutions, and local governments that meet certain criteria for energy efficiency in their products or management practices to use the Energy Star label in their marketing. The types of products that EPA has certified include lighting fixtures, home appliances, office equipment, home-construction materials, and new houses. EPA also disseminates information on sellers of labeled products and offers program participants some technical assistance in implementing changes that increase energy efficiency. Energy Star is one of several climate-protection partnerships in which EPA works to disseminate information on energy-efficient technologies and clean forms of energy.

This option would end appropriations for the Energy Star program. Doing so would save $45 million in outlays in 2008 and $268 million over the 2008–2012 period.

An argument for eliminating the program is that Energy Star labels may provide insufficient information to enlighten consumers' choices. In particular, the labels do not clarify the potential savings of a product relative to competing products. In addition, reducing energy use does not always imply reducing emissions of greenhouse gases: Coal-fired electricity-generating plants produce a large amount of carbon dioxide (a greenhouse gas), so encouraging consumers to buy an electric appliance with an Energy Star label rather than a less-efficient natural gas appliance could actually increase emissions.

An argument for maintaining the Energy Star program is that it addresses existing failures in the marketplace and that the labels and EPA's public education efforts provide consumers with some, albeit imperfect, information about energy-saving products. Insufficient consumer interest in energy efficiency may compound industry's reluctance to invest in uncertain new technologies.

RELATED OPTIONS: 270-7 and 270-8

300-11—Discretionary

Eliminate the Environmental Protection Agency's Science to Achieve Results Grant Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-72	-74	-75	-77	-78	-376	-795
Outlays	-61	-72	-75	-76	-78	-362	-779

Through its Science to Achieve Results (STAR) program, the Environmental Protection Agency (EPA) funds scientific and engineering research that is relevant to EPA's mission but which the agency lacks the resources to perform internally. Created in 1995, STAR is a competitive, peer-reviewed grant program that accounts for 15 percent to 20 percent of the research budget for EPA's Office of Research and Development, which manages the program. In 2006 the program received $69 million in appropriations, down from $100 million in 2005. (The Administration's budget request for 2008 included $61.9 million for the STAR program.)

This option would eliminate the STAR program, saving $61 million in outlays in 2008 and $362 million over five years.

STAR provides grants—typically of about $500,000 annually for several years—to leading scientists in the academic and nonprofit research communities. It also funds fellowships for graduate work in environmental sciences, with the aim of strengthening the nation's foundation in that field and attracting a continuing supply of new researchers. (Approximately 1,200 STAR fellowships have been awarded since the program's inception.) Requests for STAR grant applications are written with the help of EPA staff members who expect to be the primary users of the research. According to an independent report by the National Research Council (NRC), those requests are subjected to an "extensive" internal review before they are issued to ensure they are directed toward "issues most important to EPA" and are consistent with the agency's strategic plans. Applications submitted in response to the requests undergo a "rigorous" peer-review process, according to the NRC, that is designed to prevent conflicts of interest between proposal review and project oversight. Historically, about 10 percent of fellowship applications and slightly less than 15 percent of grant applications—about half of those that pass EPA's peer-review process—have been funded.

Critics of the STAR program cite several concerns raised by the Office of Management and Budget (OMB) in a program assessment conducted for the President's 2005 budget. The OMB concluded that STAR's research in water quality, land use, and wildlife is similar to that conducted by other federal agencies; that the program's coordination with other EPA offices and other agencies is inadequate to ensure that the agencies have access to research findings; that the program has not shown "adequate progress toward achieving long-term goals"; and that the NRC's evaluation of STAR, which was intended to improve program management, was "insufficient in scope" and failed to address the effectiveness and policy relevance of the funded research. In addition, although the NRC's evaluation was generally laudatory, it concluded that EPA makes insufficient use of outside experts in planning STAR's research agenda and that substantial delays often occur between the completion of STAR-funded research and the use of that research in related EPA rulemaking.

Supporters of STAR note the NRC's positive evaluation of the research funded by the program and the Government Accountability Office's critique of OMB's assessment methodology as a "work in progress" that needs "considerable revisions" if it is to become an "objective, evidence-based assessment tool." The NRC's evaluation stated that STAR's size relative to EPA's Office of Research and Development's total research budget is a "reasonable recognition of the value of independent, peer-reviewed research to the agency"; that the program has "established and maintains a high degree of scientific excellence"; and that it helps satisfy EPA's requirement for a "strong and balanced" research program. Moreover, the NRC concluded that the STAR program supports research that is not conducted or funded by other government agencies—particularly research related to ecology, airborne particulates, and pollution prevention—and thus expands the nation's scientific foundations in the areas of human health and the environment.

300-12—Mandatory

Scale Back the Department of Agriculture's Conservation Security Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Prohibit new enrollments	-190	-200	-279	-394	-497	-1,560	-8,367
Eliminate enhancement payments	-166	-168	-240	-336	-425	-1,336	-6,300

The Conservation Security Program (CSP), first authorized in the Farm Security and Rural Investment Act of 2002, gives agricultural producers financial and technical help to promote the conservation and improvement of soil, water, air, energy, and plant and animal life on lands used for agricultural purposes. (By contrast, the Conservation Reserve Program, which is the subject of option 300-13, encourages conservation by taking land out of agricultural production.) Under the CSP, producers enroll in 5- to 15-year contracts in which they agree to undertake various conservation measures in exchange for annual payments. For each acre enrolled in the program, producers receive a base payment equal to a percentage of their county's prevailing rental rate for similar land. In addition, they may receive an enhancement (or bonus) payment for undertaking further conservation measures. Together, those payments could exceed the cost of implementing the required conservation measures.

Because of various annual and multiyear spending constraints, the Department of Agriculture limits CSP enrollment to producers in selected watersheds. A different set of watersheds is chosen each year to focus program spending on priority areas around the country. Various laws in the past few years have limited program spending as follows: to $41.4 million in 2004, $202 million in 2005, $259 million in both 2006 and 2007, $1,954 million over the 2006–2010 period, and $5,560 million over the 2006–2015 period.

This option would curtail the Conservation Security Program in one of two ways: by prohibiting new enrollments or by allowing additional enrollments but eliminating enhancement payments, starting in 2008. The first change would reduce spending by the department's Commodity Credit Corporation (CCC) by $190 million in 2008 and by $1.6 billion over five years. The second change would reduce CCC spending by $166 million in 2008 and by $1.3 billion through 2012. (Both approaches assume that the $2.0 billion cap over 5 years and the $5.6 billion cap over 10 years would be reduced by the total amount of the savings and that no further contract modifications would be allowed.) Neither change would affect the terms of existing contracts. Even with no additional enrollments, existing contracts signed since implementation began in 2004 will cost a total of nearly $2.5 billion over the next 10 years, the Congressional Budget Office estimates.

An argument for scaling back the CSP is that certain provisions of the program cast doubt on its effectiveness. First, making payments to producers who have already adopted conservation practices does not add to the nation's conservation efforts. Less than 0.1 percent of the $177 million spent on CSP through 2005 (the last year for which data are available) was spent on new practices. Second, enhancement payments were supposed to reward participants who undertook exceptional conservation measures; however, the criteria used to determine enhancement payments are not readily apparent, and such payments have represented over 80 percent of total CSP financial assistance costs so far. Third, making payments that exceed producers' costs to adopt and maintain conservation measures could be viewed as a wasteful use of federal funds.

Supporters of the Conservation Security Program see it as a better way to support agriculture—through a form of "green payment"—than the traditional crop-based subsidies. When fully implemented, the CSP could foster the adoption of more conservation practices to protect the nation's natural and productive resources. Such practices often require significant up-front costs to undertake and could reduce the economic output of land; CSP payments might offset those costs. Further, because CSP base payments are restricted by legislation, the enhance-

ment payments, which are not subject to such restrictions, are useful in encouraging participation in the program. Finally, the high percentage of recipients receiving enhancement payments could be justified by the fact that the department has chosen to focus the program's limited funds on enrolling participants who have already demonstrated greater levels of commitment to conservation activities.

RELATED OPTION: 300-13

300-13—Mandatory

Limit Future Enrollment of Land in the Department of Agriculture's Conservation Reserve Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Return to the 36.4-million-acre limit	0	-60	-81	-79	-81	-301	-824
Prohibit new enrollments	0	-60	-81	-196	-352	-689	-3,917
Prohibit reenrollments	0	-208	-262	-548	-856	-1,873	-9,316

The Conservation Reserve Program (CRP) is intended to promote soil conservation, improve water quality, and protect wildlife habitat by removing land from active agricultural production. Landowners offer to sign contracts with the Department of Agriculture to keep land out of production, usually for 10 to 15 years, in exchange for providing annual rental payments and cost-sharing assistance for establishing appropriate conservation practices on the enrolled land. Acreage may be enrolled in one of two ways: through general enrollments, which are held periodically for larger tracts of land, or through continuous enrollments, which allow producers to offer at any time smaller tracts of land that are devoted to those conservation practices considered the most effective (such as the use of filter strips, grass waterways, and riparian buffers). Not all contract offers are accepted, however; approval is based on an evaluation of the costs and potential environmental benefits of a landowner's plan. The CRP is funded by the Department of Agriculture's Commodity Credit Corporation at about $2.1 billion to $2.6 billion per year.

Currently, some 36.7 million acres are enrolled in the CRP. Total enrollment is capped at 39.2 million acres under the 2002 Farm Security and Rural Investment Act—up from 36.4 million acres under the 1996 Federal Agriculture Improvement and Reform Act. The Congressional Budget Office estimates that enrollment in the program will reach 39.023 million acres by 2017.

This option would limit the scope of the Conservation Reserve Program in one of three ways: by restricting future enrollment to 36.4 million acres, as under the 1996 farm law, reducing outlays by $301 million over the 2008–2012 period; by prohibiting new general enrollments, beginning in 2008, but allowing current participants to reenroll when their contracts expired, reducing spending by $689 million through 2012; or by prohibiting any new general enrollments (including reenrollments), beginning in 2008, lowering spending by $1.9 billion through 2012. The savings from reducing CRP payments would be net of offsetting costs from additional spending for commodity programs, especially marketing-assistance loan benefits, because some land formerly in CRP contracts would return to production.

Under the second and third approaches, the amount of land enrolled in the CRP would drop significantly. Current contracts covering about 16 million acres were set to expire in 2007, as were contracts for another 6 million acres in 2008. However, the department offered contract holders an opportunity to extend some contracts up to the maximum of 15 years, thus delaying their expiration. Without new enrollments, by 2017, acreage in the CRP would total 26.0 million if reenrollment was permitted and 5.3 million if it was not.

Although there is widespread agreement about the need to take at least some environmentally sensitive land out of production, some supporters of scaling back the CRP see the program as expensive and poorly focused. They argue that the CRP's funding could be put to other uses that would provide greater environmental benefits. Other supporters of limiting the program worry that retiring large amounts of cropland in a given area could dampen economic activity (for example, by reducing the demand for seed, fertilizer, and other farm supplies), thus hurting rural communities. Also, reducing CRP enrollment could free more land for corn and biomass production for ethanol.

Opponents of scaling back the CRP note that the program helps landowners because its payments are often larger and more certain than profits from continued

agricultural production; it particularly helps those participants for whom putting the land back into production is an unattractive option. Conservationists and environmentalists particularly support the Department of Agriculture's plan to accept the most environmentally sensitive land in future enrollments. Studies have indicated that the CRP yields high returns—in enhanced wildlife habitat, improved water quality, and reduced soil erosion—for every dollar spent.

RELATED OPTION: 300-12

300-14—Discretionary

Eliminate the National Park Service's Local Funding for Heritage Area Grants and Statutory Aid

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-20	-21	-21	-22	-22	-106	-205
Outlays	-20	-21	-21	-22	-22	-106	-205

The National Park Service runs two programs—National Heritage Area (NHA) grants and Statutory Aid—that assist local efforts to establish, preserve, or operate areas of natural, historical, cultural, or recreational importance. Locations that have been designated National Heritage Areas by the Congress are eligible for grants under the first program. Under the second, each individual allocation of statutory aid must be given a specific authorization. Sites that receive support from either program are not operated or managed by the National Park Service but rather by state or local agencies, nonprofit groups, or private partnerships. As of 2006, 27 sites had been designated National Heritage Areas and had received grants. Twelve sites received statutory aid in 2006 (there were 20 such sites in 2005, including 8 that received statutory aid in both years). The Administration has proposed eliminating both programs in the past (while still supporting existing Heritage Areas and three current recipients of statutory aid through the Department of the Interior's Historic Preservation Fund and the National Park Service's operations budget, respectively). The Congress trimmed the NHA grant program budget by 9 percent in 2006, to $13.3 million, and cut Statutory Aid by 37 percent, to $7 million, compared with 2005 appropriations.

This option would eliminate funding for both NHA grants and Statutory Aid. Ending those programs would reduce discretionary outlays by $20 million in 2008 and by $106 million between 2008 and 2012.

NHA grants are intended to serve as "seed money" to help the organizations that receive them become self-sustaining by setting up partnerships with state and local governments, nonprofit groups, and businesses to fund ongoing operations. Those grants are limited to no more than $1 million annually for up to 15 years (with a total cap of $10 million) for areas designated since 1996. Heritage areas may receive other federal funding as well (primarily from the Department of Transportation for road and infrastructure improvements). By statute, half of their funding must come from nonfederal sources. The Statutory Aid program provides financial assistance on an as-needed basis to local efforts to establish, preserve, and operate such sites. Both programs are intended to allow the National Park Service to extend its mission of preserving nationally significant natural and historical resources without acquiring and managing those resources itself.

The Government Accountability Office (GAO) has criticized the National Park Service's administration of the NHA grant program. According to GAO, the Park Service lacks systematic processes for identifying potentially qualified NHA sites and recommending them to the Congress for approval; it has not established "results-oriented performance goals and measures" in its oversight of heritage areas; and it has failed to track federal funding or determine the appropriateness of expenditures for the program. (However, the Park Service maintains that it has not been funded to carry out those latter tasks.) GAO also contends that the "sunset" provisions (dates for grant aid to end) included in the NHA program have been ineffective. Since the first area was designated in 1984, six areas have reached their original sunset dates. However, at least five have had those dates extended by the Congress and have continued to receive funding under the originally enacted authorization levels. Nine heritage areas designated in 1996 sought similar extensions in 2006.

One argument for eliminating the NHA grant program is that the local groups receiving grants have failed to become self-sufficient, as evidenced by the continued funding of heritage areas past their sunset dates. Moreover, the efforts funded by that program and the Statutory Aid program are—in the words of the Park Service itself—"secondary to the primary mission of the National Park Service."

An argument against eliminating the programs is that public interest in creating new heritage areas is growing. GAO notes that the number of bills introduced in the Congress to study or designate new heritage areas has risen considerably in recent years. Thirty such bills were submitted in the 109th Congress. In addition, both programs are said to protect important resources.

350

Agriculture

Most of the programs that support farm income, promote agricultural research, and enhance marketing opportunities for farmers are contained in function 350. Those activities are administered by the Department of Agriculture. Mandatory programs—which account for most of the spending—include revenue support for producers of major crops (including corn, cotton, soybeans, and wheat), crop insurance, and farm credit programs. Discretionary programs include agricultural research and extension, economic analysis and statistics collection, plant and animal health inspection, agricultural marketing, and some international food aid. The Congressional Budget Office estimates that outlays for function 350 will total $20 billion in 2007.

Spending for farm income-support programs, which extends through 2007 under the Farm Security and Rural Investment Act of 2002, is projected to decline from $18 billion in 2006 to $10 billion in 2007 because of higher crop prices caused by strong demand from abroad, increased demand for ethanol (a gasoline additive made from corn), and crop damage attributable to recent bad weather across the country. The decrease in spending for the farm income-support programs is partially offset by an increase in spending for the federal crop insurance program, as higher crop prices bolster the value of crops and insurance alike.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

	2002	2003	2004	2005	2006	Estimate 2007[a]	Average Annual Rate of Growth (Percent) 2002-2006	2006-2007
Discretionary Budget Authority	5.6	6.2	5.8	5.9	6.0	5.8	1.4	-3.2
Outlays								
Discretionary	5.2	5.6	5.8	6.0	5.8	5.8	2.8	0.8
Mandatory	16.8	16.9	9.7	20.6	20.2	13.9	4.7	-31.1
Total	22.0	22.5	15.4	26.6	26.0	19.7	4.3	-24.0

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (PL. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

350-1—Mandatory

Eliminate the Research Initiative for Future Agriculture and Food Systems

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	0	0	-200	-200	-200	-600	-1,600
Outlays	0	0	-30	-100	-160	-290	-1,290

The Initiative for Future Agriculture and Food Systems is a competitive grant program designed to support research, extension, and education activities in areas designated as priorities for U.S. agriculture. The program funds research into and activities involving food genomics, food safety, human nutrition, alternative uses for agricultural commodities, biotechnology, and "precision farming" (which entails the precise monitoring and control of livestock as well as crop- or forest-management practices focusing on a specific area rather than on an entire field or forest). The Agricultural Research, Extension, and Education Reform Act of 1998 created and provided mandatory funding for the initiative. The program was reauthorized in the Farm Security and Rural Investment Act of 2002 and was mandated to receive rising annual appropriations—$120 million for 2004, growing to $200 million for 2007 and later years. The Deficit Reduction Act of 2005 suspended funding for the program until 2010.

This option would eliminate the Initiative for Future Agriculture and Food Systems, reducing mandatory outlays by $30 million in 2010 and by $290 million through 2012.

One argument for ending the program is that, if agricultural research needed federal support, it might be able to receive that support through discretionary funding (which is subject to annual Congressional review) rather than mandatory funding. That is the approach used for another $2 billion or so of agricultural research funding elsewhere in the Department of Agriculture's budget. For most of the program's existence, the Congress has chosen to block mandatory funding for the program in the appropriation process and divert the budgetary savings to other purposes. Further, because each year's funding is made available for obligation over two years, annual appropriations language prohibiting spending for the program could be credited with saving the same funding twice (for example, the $200 million in funding authorized in 2010 could be blocked in the appropriation process both in 2010 and 2011). Finally, federal funding for agricultural research might merely be replacing private funding and thus not filling a vital national need.

The main rationale for keeping the initiative is that various factors—such as competition from foreign producers, increased attention to food-safety issues, and the growing pace of technological change in agriculture—have increased the need for research funding beyond what is available through traditional discretionary programs. More generally, the program may be important for improving agricultural productivity, environmental quality, and farm income.

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

350-2—Mandatory

Impose New Limits on Payments to Producers of Certain Agricultural Commodities

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-24	-109	-110	-109	-112	-462	-1,036

The government supports producers of various farm commodities—including cotton, feed grains, oilseeds, peanuts, rice, and wheat—in three main ways. First, producers can receive direct payments on the basis of their historical production (those payments are not affected by market prices). Second, producers may be entitled to additional payments, known as countercyclical payments, which depend on market prices. Third, they can receive benefits from the marketing-assistance loan program, which essentially guarantees them a minimum price for their crop. Under that program, producers take out loans at harvest whose value is tied to the minimum price, using the crops from that harvest as collateral. If the market price falls short of the loan value in subsequent months, producers receive marketing-assistance loan benefits, which amount to partial forgiveness of the loan. Payments, which are made by the Department of Agriculture's Commodity Credit Corporation (CCC), are based on a specified amount per unit (bushel or pound) of eligible production on the farm. Hence, larger farms earn larger payments.

Since 1970, the amount that a producer can collect under those programs has been subject to a dollar limit. Currently, those limits are $40,000 for direct payments, $65,000 for countercyclical payments, and $75,000 for marketing-assistance loan benefits. However, the limits are per person, with "person" defined as including individuals, corporations, and other legal entities. An individual producer, therefore, might qualify for payments through up to three different farming entities, with the effect of receiving twice the nominal limits. For example, the producer could receive $40,000 in direct payments as an individual and $20,000 (up to a 50 percent share) in direct payments as an owner of two separate corporations that produced agricultural commodities, for a total of $80,000 in direct payments.

This option would cut the current payment limits in half for two of those programs—to $20,000 per person for direct payments and $32,500 per person for countercyclical payments—while retaining the three-entity rule. It would leave the cap on marketing-assistance loan benefits at $75,000 per person but would modify the program to include generic certificates and loan-forfeiture gains as part of that cap.[1] Savings in CCC payments would amount to $24 million in 2008 and $462 million over five years. Most of the savings would come from reducing the limit on direct payments, primarily because total countercyclical payments and marketing-loan benefits are projected to be relatively low over the next several years as a result of higher commodities prices.

Policy positions about payment limits, both pro and con, are heavily influenced by perceptions of fairness. Advocates of lowering the limits generally view the purpose of farm support programs to be keeping smaller, family farms in business, particularly those that are struggling financially. Payment limits are intended both to reduce overall federal spending on farm programs and to promote greater equity in the distribution of program benefits. Lower limits would not directly increase payments to small producers, but they would reduce the budgetary costs of the programs and the proportion of total payments going to large farms. Thus, supporters of the option maintain, lower limits could help small farms indirectly, slowing the rate at which such farms are lost by reducing larger farmers' incentives to buy them to expand operations.

1. Generic-certificate gains are an alternative means of settling marketing-assistance loans whenever the market price is less than the loan rate. Although the final result is similar in value to marketing-assistance loan benefits, certificate gains do not count as cash payments for purposes of payment limits. Loan-forfeiture gains are the additional income that producers may derive from forfeiting their marketing-assistance loan when the market price falls below the loan rate. Rather than repaying the loan, the producers keep the proceeds but turn over their collateral crop to the Department of Agriculture.

Opponents of the option argue that farm programs are not intended or well suited to provide a more equal distribution of income among farm households. They also contend that payment limits undermine the competitiveness of U.S. agriculture in global markets. Some producer organizations have called for eliminating the limits altogether, saying that tighter restrictions on program benefits hurt the larger, more efficient farming operations that are better able to take advantage of economies of scale in production. Opponents also note that reducing the payment limits would affect different commodities and regions differently. Because cotton and rice have a relatively high value of program benefits per acre, most of the option's savings would come from producers of those crops, and the effect on the agricultural sector would be largest in the Southern and Western states where they are concentrated.

RELATED OPTION: 350-3

350-3—Mandatory

Reduce Payment Acreage by 1 Percentage Point

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-13	-68	-74	-72	-73	-300	-683

Direct and countercyclical payments to agricultural producers (described in Option 350-2) are expected to make up about 86 percent of the Commodity Credit Corporation's (CCC's) total spending for program commodities—wheat, feed grains, oilseeds, cotton, rice, and peanuts—over the next 10 years. Those payments are calculated as 85 percent of a producer's base acreage times an assumed yield per acre times a payment rate per unit (bushel, pound, or hundredweight) of production. In general, a farm's base acreage for each eligible crop is calculated as the average number of acres planted with that crop between 1998 and 2001. Direct and countercyclical payments are made regardless of what is currently produced on the farm; hence, those payments tend not to distort people's decisions about production. Program participants may also receive benefits for those commodities through marketing-assistance loans, which are paid according to actual farm production.

This option would reduce the eligible payment acreage for direct and countercyclical payments by 1 percentage point—from 85 percent to 84 percent. That change would lower the CCC's outlays for farm programs by $13 million in 2008 and by $300 million over the 2008–2012 period.

Producers of commodities that are not covered by direct and countercyclical payments—such as dairy products, dry peas, lentils, mohair, small chickpeas, sugar, and wool—receive federal benefits primarily through marketing-loan gains, loan-deficiency payments, or purchases. Proportionately reducing program benefits for those commodities to the reductions in this option would lower CCC spending by an additional $8 million over the 2008–2012 period. Such a decrease would most likely be accomplished through a reduction in the applicable marketing-assistance loan rate.

The primary advantage of reducing payment acreage is that it would yield significant savings with a relatively small adjustment in program provisions. The spending cuts would affect all program participants in proportion to their expected payments instead of disproportionately affecting producers of any particular commodity. In contrast, spending reductions resulting from changes in payment limits (the subject of Option 350-2) would tend to have a particularly large impact on producers of cotton and rice.

The main disadvantage of this option is that the cuts in commodity programs would target the least market-distorting payments (direct and countercyclical payments) rather than marketing-loan benefits, which essentially guarantee a minimum level for the prices received by participating producers of certain crops. In addition, although reducing payment acreage would be relatively straightforward, achieving proportionate reductions in spending for other commodities would be more complicated.

RELATED OPTION: 350-2

350-4—Mandatory

Reduce the Reimbursement Rate Paid to Private Insurance Companies in the Crop Insurance Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-46	-49	-50	-50	-50	-245	-493
Outlays	-41	-49	-50	-50	-50	-240	-488

The Federal Crop Insurance Program protects farmers from losses caused by drought, flooding, pest infestation, and other natural disasters. Farmers can choose among policies that provide various levels and types of protection (for example, against yield losses only, or against both yield losses and low prices). Insurance policies that farmers buy through the program are sold and serviced by private insurance companies, which receive reimbursement for their administrative costs on the basis of the types of policies they sell and the amount of premiums they collect. Companies also share underwriting risk with the federal government and can gain or lose depending on the extent of crop losses and indemnity claims. Overall, the companies typically gain.

The maximum reimbursement rate for administrative costs was reduced in 1998 from 27 percent to 24.5 percent of premiums. In 2004, under the reinsurance agreement that was negotiated between insurance companies and the Department of Agriculture, the maximum reimbursement rate was reduced again, to 24.2 percent of premiums.

This option would further reduce the maximum rate to 23.2 percent of premiums (with comparable reductions for types of policies that are currently reimbursed at less than the maximum rate). That reduction in reimbursement rates would save $41 million in outlays in 2008 and $240 million over the 2008–2012 period.

Proponents of this option believe that lawmakers could cut the reimbursement rate below the rates agreed to in 2004 without substantially affecting the quantity or quality of services provided to farmers, partly because total insurance premiums and reimbursements have been rising faster than the administrative costs of selling and servicing policies. They note that, notwithstanding the rate reduction in 2004, reimbursements per acre insured increased by over 25 percent between 2000 and 2006, to some extent because coverage levels on acreage already insured have increased, yielding higher premiums without a corresponding increase in administrative costs. (Increased coverage levels are one result of the Agricultural Risk Protection Act of 2000, which significantly lowered the cost of insurance to farmers.) Proponents also assert that even if cuts caused some companies to curtail services to farmers or to drop out of the market, other companies could take up the slack and that any effects on the program would not be significant.

An argument against this option is that further cuts could impair the ability of the crop insurance industry to sell and service policies and would threaten farmers' access to insurance. Opponents of the option point to the 2002 failure of the largest insurance company participating in the program as evidence that reimbursements for expenses are already too low and that further reductions would make it even harder for companies to maintain the services they now provide to farmers. If the crop insurance program failed, opponents say, lawmakers would be more likely to resort to expensive, special-purpose relief programs when disaster struck, negating any apparent savings from cutting the reimbursement rate.

RELATED OPTION: 450-9

350-5—Mandatory

Eliminate the Foreign Market Development Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-24	-31	-35	-35	-35	-160	-335

The Department of Agriculture's Foreign Agricultural Service (FAS) administers various programs that promote exports of agricultural products from the United States and provide nutritional and technical assistance to other countries. In the Foreign Market Development Program, FAS acts as a partner in joint ventures with "cooperators"—such as agricultural trade associations and commodity groups—to develop markets for U.S. exports. The program, also known as the Cooperator Program, typically promotes generic products and basic commodities, such as grains and oilseeds, although it also covers some higher-value products, such as meat and poultry.

This option would eliminate funding for the Foreign Market Development Program, reducing mandatory outlays by $24 million in 2008 and by $160 million over five years.

Supporters of implementing the option argue that the Cooperator Program merely replaces private spending with public spending and that the cooperators should bear the full cost of foreign promotions because they directly benefit from those promotions. They also argue that the program's services duplicate those of FAS's Market Access Program (described in Option 350-6), which similarly works to create and expand foreign markets for U.S. agricultural products.

Opponents of the option argue that ending federal funding for the Cooperator Program could place U.S. exporters at a disadvantage in international markets because other countries provide support to their exporters. They also contend that the Cooperator Program does not duplicate other programs, partly because it focuses on basic commodities and sales to foreign manufacturers and wholesalers. Moreover, some analysts contend, the program helps the U.S. economy as a whole—not just the cooperators—by reducing the trade deficit. However, analysis shows that government efforts to support or subsidize exports have at best a temporary effect on the trade deficit, which is largely driven by the difference between domestic investment and domestic saving. Moreover, by distorting the allocation of economic resources, such efforts generally impose costs that exceed their benefits.

RELATED OPTIONS: 150-1, 350-6, 350-7, and 370-1

RELATED CBO PUBLICATIONS: *The Effects of Liberalizing World Agricultural Trade: A Review of Modeling Studies*, June 2006; *The Effects of Liberalizing World Agricultural Trade: A Survey*, December 2005; *The Decline in the U.S. Current-Account Balance Since 1991*, August 6, 2004; and *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

350-6—Mandatory

Reduce Funding for the Market Access Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-3	-48	-60	-60	-60	-231	-531

The Market Access Program, administered by the Department of Agriculture's Foreign Agricultural Service (FAS), provides funds to trade associations, commodity groups, and for-profit firms to help them build markets overseas for U.S. agricultural products. Under current law, funding for the program increased from $100 million in 2002 to $200 million in 2006 and ensuing years.

This option would reduce funding for the Market Access Program in 2008 and subsequent years to $140 million, the same level of funding authorized for the program in 2005. That change would reduce mandatory outlays by $231 million over the 2008–2012 period.

The Market Access Program promotes the export of a wide range of products, including eggs, fruit, meat, poultry, seafood, tree nuts, and vegetables. About 20 percent of the program's funding goes to promote brand-name goods. The program requires varying degrees of cost sharing: For promotions of brand-name products, cooperatives or small private firms must pay at least 50 percent of the overall costs; for promotions of generic products, trade associations and others must pay at least 10 percent of those costs.

Some supporters of this option argue that the Market Access Program does not warrant additional funding because the extent to which it has developed markets or replaced private expenditures with public funds is uncertain. Others argue that taxpayers' money should not be spent to advertise brand-name products and that participants should bear the full cost of foreign promotions because they directly receive the benefits. Further, some proponents of the option note that the Market Access Program duplicates the FAS's Foreign Market Development Program (described in Option 350-5), which also provides funds for overseas marketing. Lastly, those in favor of implementing the option say that federal intervention to promote exports distorts the allocation of economic resources and has no lasting impact on the trade deficit, according to analysis that indicates the deficit depends primarily on the gap between domestic investment and domestic saving.

An argument against reduced funding for the Market Access Program is that in recent years it has targeted its funds toward small companies and cooperatives and reduced the share that goes to promoting brand-name products. Furthermore, limiting the program could place U.S. exporters at a disadvantage in international markets because other countries support their exporters. On the issue of duplication, some opponents of this option maintain that the Market Access Program differs from other programs partly because it focuses on specialty crops, processed products, and consumer promotions.

RELATED OPTIONS: 150-1, 350-5, 350-7, and 370-1

RELATED CBO PUBLICATIONS: *The Effects of Liberalizing World Agricultural Trade: A Review of Modeling Studies*, June 2006; *The Effects of Liberalizing World Agricultural Trade: A Survey*, December 2005; *The Decline in the U.S. Current-Account Balance Since 1991*, August 6, 2004; and *Causes and Consequences of the Trade Deficit: An Overview*, March 2000

350-7—Mandatory

Limit the Repayment Period for Export Credit Guarantees

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-37	-37	-37	-37	-37	-185	-370
Outlays	-20	-36	-37	-37	-37	-167	-352

The Department of Agriculture promotes the export of U.S. farm products through several credit guarantee programs administered by the Foreign Agricultural Service. Those programs protect exporters and banks in the United States against default on financing they provide to foreign importers and banks to cover purchases of U.S. goods. Under those programs, if the foreign recipients of export credit fail to repay what they owe, the federal government makes up most of the shortfall.

The principal export credit guarantee programs for agricultural products are the Export Credit Guarantee Program, which covers credit with repayment terms of up to three years, and the Supplier Credit Guarantee Program, which covers credit with terms of up to six months. The Department of Agriculture has implemented a series of changes to those programs over the past several years. In 2005, in response to findings by a dispute-resolution panel of the World Trade Organization, loan fees for the Export Credit Guarantee Program were increased, and higher-risk countries were excluded from the program. In 2006, in response to increasing loan losses, lending under the Supplier Credit Guarantee Program was suspended.

This option would restrict the repayment period for the Export Credit Guarantee Program to no more than six months, reducing mandatory outlays by $20 million in 2008 and by $167 million through 2012.

Supporters of this option contend that the credit guarantees of up to three years provided under the Export Credit Guarantee Program offer substantial benefits to participating foreign and domestic banks but have little, if any, impact on the overall level of U.S. agricultural exports. A September 1997 report by the General Accounting Office (now the Government Accountability Office) found little evidence that those programs provided measurable income or employment benefits to U.S. agriculture. Moreover, in ongoing multilateral trade negotiations, the United States has expressed support for limiting the term of its credit guarantee programs to no more than six months if other countries agree to eliminate their export subsidy programs. Furthermore, some advocates of the option argue that government programs that support or subsidize exports hurt the economy as a whole by distorting the allocation of economic resources and thus imposing costs that exceed their benefits.

Opponents of implementing this option say that the United States should not cut back its export credit programs without parallel changes in the export subsidy programs of other countries. Other advocates of the program maintain that the current longer-term credit guarantees reduce the cost of financing purchases and allow suppliers in the United States to increase sales in countries where they could not otherwise provide financing.

RELATED OPTIONS: 150-1, 350-5, 350-6, and 370-1

RELATED CBO PUBLICATIONS: *The Effects of Liberalizing World Agricultural Trade: A Review of Modeling Studies,* June 2006; *The Effects of Liberalizing World Agricultural Trade: A Survey,* December 2005; *The Decline in the U.S. Current-Account Balance Since 1991*, August 6, 2004; *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees,* August 2004; and *Causes and Consequences of the Trade Deficit: An Overview,* March 2000

370

Commerce and Housing Credit

Programs that promote and regulate U.S. commerce at home and abroad include initiatives of the Small Business Administration (SBA), the Federal Housing Administration (FHA), the Postal Service, the Federal Deposit Insurance Corporation, and the Department of Commerce. Activities in function 370 provide trade assistance to promote U.S. products to overseas markets, fund small business loans, provide deposit insurance for banks and credit unions, and underwrite home mortgage guarantees. The Universal Service Fund, which supports affordable telecommunications services throughout the nation, is the function's largest program, with outlays for 2007 projected at $7.8 billion.

The Securities and Exchange Commission, the Federal Communications Commission (FCC), the Federal Trade Commission, and the Patent and Trademark Office, also included in function 370, generate fees that offset spending. Proceeds from spectrum auctions run by the FCC are recorded in budget function 950 (undistributed offsetting receipts); however, budget options involving those auctions are included in this section.

For 2007, outlays for this budget function are estimated to total $1.2 billion, about $5 billion (81 percent) less than in 2006. Generally, fluctuations in annual outlays for function 370 are caused by periodic revisions in the estimates of the cost of FHA and SBA credit programs.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

	2002	2003	2004	2005	2006	Estimate 2007[a]	Average Annual Rate of Growth (Percent) 2002-2006	2006-2007
Discretionary Budget Authority	0.6	-0.3	*	2.6	1.9	2.7	32.6	44.1
Outlays								
Discretionary	1.0	-0.6	0.1	2.1	1.8	2.9	17.3	58.7
Mandatory	-1.4	1.3	5.1	5.4	4.3	-1.7	n.a.	n.a.
Total	-0.4	0.7	5.3	7.6	6.2	1.2	n.a.	-81.0

Note: * = between -$50 million and zero; n.a. = not applicable (because of a negative value in the first or last year).

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 7 *Reduce the Mortgage Interest Deduction or Replace It with a Tax Credit*

Revenue Option 27 *Tax Large Credit Unions in the Same Way as Other Thrift Institutions*

Revenue Option 31 *Repeal the Low-Income Housing Credit*

Revenue Option 37 *Tax the Federal Home Loan Banks Under the Corporate Income Tax*

Revenue Option 50 *Eliminate the Federal Communications Excise Tax and Universal Service Fund Fees*

Revenue Option 59 *Charge for Examinations of State-Chartered Banks*

Revenue Option 60 *Fund the Commodity Futures Trading Commission Through Fees*

Revenue Option 65 *Impose Fees on the Portfolios of Government-Sponsored Enterprises*

370-1—Discretionary

Eliminate the International Trade Administration's Trade Promotion Activities or Charge the Beneficiaries

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-407	-420	-432	-446	-459	-2,164	-4,680
Outlays	-305	-380	-424	-437	-450	-1,996	-4,463

The International Trade Administration (ITA) of the Department of Commerce runs a trade development program that assesses the competitiveness of U.S. industries and promotes exports. The ITA also operates the U.S. and foreign commercial services, which counsel U.S. businesses on issues related to exporting. The agency charges some fees for those services, but the fees do not cover the costs of all such activities.

This option includes two alternatives: Eliminate the ITA's trade promotion activities or charge the beneficiaries for those services. Either change would save $305 million in outlays in 2008 and a total of about $2.0 billion through 2012.

The principal rationale for this option is that business activities such as trade promotion are usually better left to the firms and industries that stand to benefit from those activities rather than to a government agency. Having the government engage in such activities (without charging the beneficiaries for their full cost) is an expensive means of helping the firms and industries because the benefits are partially passed on to foreigners in the form of lower prices for U.S. exports. Moreover, the lower prices could result in some products' being sold abroad for less than the cost of production and sales and, thus, could lower U.S. economic well-being. Further, in the most recent Program Assessment Rating Tool evaluation, the Office of Management and Budget concluded that businesses can obtain services similar to those of ITA's foreign commercial services from state, local, and private-sector entities.

An argument against eliminating the ITA's trade promotion activities is that such activities are subject to some economies of scale, so having one entity (the federal government) counsel exporters about foreign legal and other requirements, disseminate information about foreign markets, and promote U.S. products abroad might make sense. An alternative way to reduce net federal spending but continue the ITA's activities would be to charge the beneficiaries for their full costs. Fully funding the ITA's trade promotion activities through voluntary charges, however, could prove difficult or impossible. For example, in many cases, it would not be possible to promote the products of selected firms that were willing to pay for such promotion without also promoting the products of other firms in the same industry. In those circumstances, firms would have an incentive not to purchase such services because they would be likely to receive the benefits regardless of whether they paid for them. Consequently, if the federal government wanted to charge beneficiaries for the ITA's services, it might have to require that all firms in an industry (or the industry's national trade group) decide collectively whether to buy the services. If the firms opted to purchase the services, all firms in the industry would be required to pay according to some equitable formula.

RELATED OPTIONS: 150-1, 350-5, 350-6, and 350-7

RELATED CBO PUBLICATIONS: *The Decline in the U.S. Current-Account Balance Since 1991,* August 6, 2004; and *Causes and Consequences of the Trade Deficit: An Overview,* March 2000

370-2—Discretionary

Eliminate the Hollings Manufacturing Extension Partnership and the Baldrige National Quality Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-94	-96	-98	-100	-102	-490	-1,035
Outlays	-15	-62	-85	-95	-99	-356	-886

In addition to its various research and development activities, the National Institute of Standards and Technology oversees two programs designed to improve the performance of U.S. businesses: the Hollings Manufacturing Extension Partnership (HMEP) and the Baldrige National Quality Program. The HMEP program consists primarily of a network of manufacturing extension centers that help small and midsize firms by providing expertise in the latest management practices and manufacturing techniques, as well as other knowledge. The nonprofit centers are not owned by the federal government but are partly funded by it. The National Quality Program consists mainly of the Malcolm Baldrige National Quality Award, which is given to companies (and, in recent years, to education and health care institutions) for achievements in quality and performance.

This option would eliminate the Hollings Manufacturing Extension Partnership and the Baldrige National Quality Program, reducing discretionary outlays by $15 million in 2008 and by $356 million through 2012.

Proponents of this option question whether it is appropriate or necessary for the government to provide technical assistance such as that offered by the HMEP program. Many professors of business, science, and engineering serve as consultants to private industry, and other ties between universities and private firms further facilitate the transfer of knowledge. For example, some of the centers that HMEP subsidizes predate the program. In the most recent Program Assessment Rating Tool evaluation, the Office of Management and Budget (OMB) noted that, according to a recent survey by the Modernization Forum, half of HMEP clients said that the services they obtained from the program were available from alternative sources, although at a higher cost.

HMEP's positive effect on productivity also is questionable. In many cases, federal spending for HMEP allows inefficient companies to remain in business, tying up capital, labor, and other resources that otherwise could be used more productively elsewhere. Moreover, according to OMB's evaluation, manufacturing extension centers originally were intended to become self-sufficient, supported entirely by fees and perhaps state contributions. However, the program still recovers only one-third of its costs through fees. To promote self-sufficiency, the President's budget requests in the recent past have recommended that individual centers be funded for no longer than six years. The President's 2008 budget proposes a reduction of more than 50 percent from the 2006 grant level.

Opponents of eliminating the HMEP program point to the economic importance of small and midsize companies, which they say produce more than half of U.S. output and employ two-thirds of U.S. manufacturing workers. They maintain that small firms often face limited budgets, lack of expertise, and other barriers to obtaining the sort of information that HMEP provides. Moreover, larger firms rely heavily on small and midsize companies for supplies and intermediate goods. For those reasons, opponents of the option say, the HMEP program promotes U.S. productivity and international competitiveness.

An argument for eliminating the Baldrige National Quality Program is that businesses need no government incentives to maintain the quality of their products and services—the threat of lost sales is sufficient. Furthermore, winners of the Baldrige Award often mention it in their advertising, which means that they value the award. If so, they should be willing to pay contest entry fees large enough to eliminate the need for federal funding. The primary argument for retaining the Baldrige National Quality Program is that it promotes U.S. competitiveness in the business, education, health care, and nonprofit sectors.

370-3—Mandatory

Permanently Extend the Federal Communications Commission's Authority to Auction Licenses for Use of the Radio Spectrum

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	0	0	+35	+35	-1,250

Note: Proceeds from spectrum auctions are recorded in budget function 950 (undistributed offsetting receipts)

In 1993, the Federal Communications Commission (FCC) was first granted limited authority to use competitive bidding to assign licenses for use of the radio spectrum. The Balanced Budget Act of 1997 went further—not just permitting but requiring the FCC to auction licenses in all circumstances in which more than one private applicant sought a license. From 1994 through 2006, those auctions generated a total of about $35 billion in federal receipts.

This option would permanently extend the FCC's authority to auction spectrum licenses, which is set to expire at the end of 2011. Extending that authority would produce $1.25 billion in additional offsetting receipts (which are credited against direct spending) over the next 10 years. This policy would increase the FCC's direct spending for auction costs by about $35 million in 2012, but proceeds from those auctions probably would not be recorded until the following year. (The President's budget for 2008 includes a similar proposal.)

One rationale for such action is that the receipts raised by auctioning licenses compensate the public for private use of the radio spectrum. Moreover, competitive bidding directly places licenses in the hands of the parties that value them most—a more efficient outcome than that produced by lotteries or comparative hearings, the methods previously used to assign licenses. (In a comparative hearing, entities that wished to be granted a license made their case to the FCC in terms of the public-interest standard, an imprecise criterion by which authority to use the spectrum was supposed to go to the parties that would make the best use of it from society's point of view.)

Opponents of extending the FCC's authority maintain that, as currently constituted, the auctions no longer advance competition in the telecommunications-services markets. They argue that the prices auction winners pay for the right to use the radio spectrum in major cities are so high that only very large companies can afford those rights. The result is that new companies are unable to enter the highly concentrated markets that provide high-speed Internet access, much less compete with the local telephone and cable companies that dominate those markets. (Outside of the top markets, however, the winning bids for spectrum are much lower, permitting entry into smaller markets where the need for additional providers of broadband is greatest.)

Another argument against implementing the option is that the prospect of auction receipts has caused the FCC to allocate too little of the radio spectrum for unlicensed uses, such as wireless Internet access. (The use of unlicensed spectrum is especially attractive for Internet access in rural areas because it is difficult for service providers to acquire the right to use licensed spectrum in small quantities.) However, the agency has allocated additional spectrum for unlicensed uses several times since 1993 and is currently considering other allocations for such uses. The FCC also is looking into allowing more use of unlicensed low-power devices that can share parts of the spectrum primarily allocated for licensed use without causing significant interference.

RELATED OPTIONS: 370-4 and 370-5

RELATED CBO PUBLICATIONS: *Small Bidders in License Auctions for Wireless Personal Communications Services,* October 2005; and *Where Do We Go from Here? The FCC Auctions and the Future of Radio Spectrum Management,* April 1997

370-4—Mandatory

End Small-Bidder Preferences in Auctions Conducted by the Federal Communications Commission for Wireless Spectrum Licenses

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-100	-25	-5	-5	-5	-140	-140

Since the mid-1990s, the Federal Communications Commission (FCC) has used competitive auctions to assign licenses for providing wireless communications services. In conducting the auctions, the FCC has complied with a statutory obligation to ensure that small businesses are able to participate in the provision of such services. The FCC has fulfilled that obligation, in part, by offering preferences in wireless spectrum auctions that are intended to reduce the amount that small bidders must pay in order to win licenses. Preferences have included setting aside licenses for small bidders, offering bidding credits (that is, government subsidies of a fixed percentage of small bidders' winning bids), and allowing small bidders to pay for the licenses they win through installment payments at federally subsidized rates of interest.

This option would eliminate small-bidder preferences in future FCC auctions of wireless spectrum licenses. As a result, all auction participants would bid on the same set of licenses, and their bids would be treated equally in determining license winners. The Congressional Budget Office estimates that the option would yield savings of $100 million in 2008 and $140 million over five years. The estimate assumes that legislation making the change is enacted at least six months before the start of the auction of frequencies recovered as a result of the transition to digital television.

Advocates of this option argue that small-bidder preferences in wireless spectrum auctions are both economically inefficient and difficult to administer. They are economically inefficient because small businesses are less able than larger ones to establish and operate wireless communications networks. As a result, licenses won by small bidders through auction preferences often end up in the hands of larger wireless firms. Thus, it would be better simply to award licenses to those willing to pay the most for them at auction in the expectation that a higher bid would most likely reflect the higher revenue stream resulting from a more productive use of the license in the future.

Advocates of this option also argue that small-bidder preferences are difficult to administer and that large concerns regularly provide substantial financial support to small bidders. As a result, proponents claim, such small bidders effectively bid on behalf of the larger entities that back them. Supporters of the option also note that total receipts in recent auctions would have been 1 percent to 2 percent higher if those licenses won by small bidders had instead gone to the next-highest bidders not eligible for the credits. Finally, advocates of this change argue that there are other ways to improve the prospects of small businesses in FCC auctions, such as making licenses potentially more affordable to small bidders by reducing the amount of wireless spectrum, the geographic coverage area conveyed by a given license, or both.

Opponents of this option argue that facilitating small-bidder access to wireless spectrum licenses could make the resulting markets for communications services more competitive than they otherwise would be. Opponents also argue that federal savings from the option could be small or nonexistent because providing auction preferences to small bidders enables them to bid more effectively against larger businesses and thereby could raise the general level of winning bids, perhaps by enough to increase the government's net auction receipts.

RELATED OPTIONS: 370-3 and 370-5

RELATED CBO PUBLICATION: *Small Bidders in License Auctions for Wireless Personal Communications Services*, October 2005

370-5—Mandatory

End Support for the Telecommunications Development Fund

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-38	-3	-3	-3	-3	-50	-52
Outlays	-3	-7	-6	-5	-5	-26	-50

The Telecommunications Development Fund (TDF) was established by the 1996 Telecommunications Act to provide capital and other assistance (such as financial advice and training) to small communications firms that otherwise would have difficulty finding investors. The TDF is financed through the following mechanism: businesses that wish to participate in auctions (conducted by the Federal Communications Commission, or FCC) for wireless spectrum licenses must pay "upfront" payments; the interest that accrues on those payments is channeled to the TDF. The amount of the upfront payment essentially determines the number and type of licenses on which a participant may bid. The FCC typically retains and collects interest on upfront payments for a period ranging from several weeks before the auction to 45 days after the auction's conclusion. The commission then applies each upfront payment (without interest) to the amount (if any) that the corresponding bidder owes for a winning bid and returns the remainder.

This option would terminate financial support for the Telecommunications Development Fund. As a result, interest collected on the upfront payments of bidders in FCC wireless spectrum auctions would offset other federal spending. According to the Congressional Budget Office's estimates, the option would save $3 million in 2008 and $26 million over the 2008–2012 period.

Advocates of this option argue that capital markets should be sufficient to finance commercially viable small firms and that it should not be necessary for the government to supply venture capital. Supporters maintain that the TDF's investment in small communications firms has actually been modest, falling below the amounts paid for salaries and other expenses. Finally, proponents of the option argue that government programs already exist to support both small businesses and the application and development of advanced technologies, such as those programs administered by the Small Business Administration and the Department of Commerce (including the Manufacturing Extension Partnership and the Advanced Technology Program).

Opponents of implementing the option argue that funding from the TDF helps remedy imperfections in capital markets that can make it difficult for small firms to raise capital. A related argument is that the advice and training the TDF provides to small communications firms to help them improve their ability to access capital markets can improve the allocation of financial resources in those markets by increasing the likelihood of a good match between private investors and small firms in search of financing.

RELATED OPTIONS: 370-2, 370-3, and 370-4

RELATED CBO PUBLICATION: *Small Bidders in License Auctions for Wireless Personal Communications Services,* October 2005

370-6—Mandatory

Restrict Universal Service Fund Support to a Single Connection per Household

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-1,275	-1,500	-1,640	-1,700	-1,800	-7,915	-17,965
Outlays	-1,260	-1,490	-1,630	-1,700	-1,800	-7,880	-17,930
Change in Revenues	-1,275	-1,500	-1,640	-1,700	-1,800	-7,915	-17,965

The High-Cost Program of the Universal Service Fund, which operates under the authority of the Federal Communications Commission (FCC), provides funding to eligible telecommunications carriers in rural and other high-cost areas to reduce the prices that consumers pay for supported telecommunications services. Under current policy, the fund provides financial support for as many telecommunications connections as households in rural and high-cost areas wish to buy.

This option would allow consumers served by the High-Cost Program to choose only one subsidized connection (for instance, a wireline connection) per household and require them to pay an unsubsidized price for each additional connection (for example, a wireless connection). Restricting the number of subsidized connections to a single connection per household would reduce spending by the Universal Service Fund by about $1.3 billion in 2008 and by $7.9 billion over the 2008–2012 time frame. Implementing the option, however, would not reduce the federal deficit because the Universal Service Fund is financed through dedicated telephone fees designed to balance the fund's spending. Consequently, reductions in spending by the fund would be offset by reduced revenues. (However, the burden the program places on the economy would be correspondingly reduced.)

A rationale for this option is that the growth in payments to wireless carriers—who provide what are most likely second or third telephone connections to customers who are already buying supported wireline service—has been a major factor driving the fund's growth in spending. In 2000, the fund was disbursing no support to wireless providers, but by 2006 that support had grown to $985 million. In February 2004, the Federal-State Joint Board on Universal Service, an entity that advises the FCC about universal service, recommended that the fund support only a single connection per household as a way to control spending. However, the Congress inserted language in the FCC's appropriation laws for 2005 and 2006 forbidding the agency from spending appropriated funds to carry out the joint board's recommendation.

The joint board concluded that the single-connection option was more consistent with the goals of the law that established the fund than current policy. In particular, the board noted that the second and third connections being supported under the current system often are used for services not currently eligible for support under Universal Service—for example, faxing, Internet access, and mobile communications. Furthermore, the board stated that supporting a single connection per household would fulfill the statutory principle of sufficiency included in current law, noting, "The Joint Board and the [Federal Communications] Commission have defined sufficiency as enough support to achieve relevant universal service goals without unnecessarily burdening all consumers for the benefit of support beneficiaries." By increasing the funding for high-cost connections, the joint board reasoned, the fund would be raising costs for all other consumers beyond the necessary level and possibly pricing some current telephone subscribers out of the market.

Opponents of implementing the option argue that the Communications Act sets forth a vision of universal service in which telecommunication services and prices in rural and other high-cost areas would be roughly comparable to those in urban areas. Urban households, they reason, are not limited to one telecommunications connection at affordable rates, and rural households should have the same opportunity.

RELATED CBO PUBLICATIONS: *Factors That May Increase Future Spending from the Universal Service Fund,* June 2006; and *Financing Universal Telephone Service,* March 2005

370-7—Discretionary

Charge Government-Sponsored Enterprises Fees for Registering with the Securities and Exchange Commission

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-100	-130	-150	-170	-170	-720	-1,670
Outlays	-100	-130	-150	-170	-170	-720	-1,670

Government-sponsored enterprises (GSEs)—private financial institutions chartered by the federal government—promote the flow of credit for targeted uses, primarily within the housing and agriculture sectors. To do that, they raise funds in the capital markets partly on the strength of an implied federal guarantee, which reduces their borrowing costs and enables them to borrow larger sums than would be available to other borrowers while holding less capital. The federal government also exempts GSEs from paying state and local income taxes. In addition, four GSEs—Fannie Mae, Freddie Mac, the Federal Home Loan Bank System, and the Farm Credit System—are exempt from provisions of the Securities Act of 1933, which requires publicly traded companies to register the securities they issue with the Securities and Exchange Commission (SEC).

This option would repeal those GSEs' exemption from SEC rules, requiring them to pay registration fees and to disclose information about their securities under the Securities Act of 1933. (A fifth GSE, Farmer Mac, is already subject to SEC requirements.) Such a change would increase federal offsetting collections (which are credited against discretionary spending) by about $100 million in 2008 and by about $720 million over five years. (Of those amounts, the registration of mortgage-backed securities, or MBSs, would account for about $65 million in 2008 and $460 million over five years.) Those estimates assume that the GSEs will pay the same registration fees as other firms: about 0.52 basis points (0.0052 percent of the securities' value) in 2008. The estimates also assume that the statutory basis of SEC fees will be changed. Under current law, the SEC sets rates for registration fees in order to collect target amounts spelled out in law ($234 million in 2008, for example). Under this option, the SEC would be authorized to collect the target amounts plus additional amounts from registering GSE securities.

The main argument for this option is that it would help level the playing field between the GSEs and other firms that issue securities, including issuers of private MBSs. In addition, the disclosures required by the SEC might provide additional information about MBSs. Those disclosures could help investors predict more accurately the speed at which the underlying mortgages were paid off—a key factor affecting the value of the related MBSs. In fact, in 2006, the SEC adopted new rules to address the registration, disclosure, and reporting requirements for private asset-backed and mortgage-backed securities, although the rules do not extend to Fannie Mae and Freddie Mac.

The main argument against this option is that registration could provide little additional information to investors. In accord with recommendations made by a multiagency task force in January 2003, the GSEs have already increased their disclosures about their MBSs. Similarly, Fannie Mae voluntarily registered its common stock in March 2003 under the Securities Exchange Act of 1934. A majority of the Federal Home Loan Banks have also registered their stock after being required to do so by the Federal Housing Finance Board, their regulator. Freddie Mac and the remaining Federal Home Loan Banks plan to do so as soon as they can issue timely financial statements. Voluntary registration of stock under the Securities Exchange Act of 1934 results in the

same disclosures to stock and bond investors (but not purchasers of MBSs) that would accompany registration under the Securities Act of 1933, but registrants under the 1934 law pay no fees to the SEC. Further, registration fees would impose costs on home buyers. If the fees were fully passed on to borrowers, the closing costs on a $300,000 mortgage in 2008 would increase by about $16.

RELATED OPTIONS: Revenue Options 37 and 65

RELATED CBO PUBLICATIONS: *Measuring the Capital Positions of Fannie Mae and Freddie Mac,* June 2006; *Updated Estimates of the Subsidies to the Housing GSEs,* April 8, 2004; *Testimony on Regulation of the Housing Government-Sponsored Enterprises,* October 23, 2003; *Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions,* May 2003; and *Federal Subsidies and the Housing GSEs,* May 2001

370-8—Discretionary

Increase Fees for the Federal Housing Administration's Home Equity Conversion Mortgage Insurance

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-50	-52	-54	-57	-59	-272	-612
Outlays	-50	-52	-54	-57	-59	-272	-612

The Federal Housing Administration's (FHA's) Home Equity Conversion Mortgage (HECM) program facilitates the supply of reverse mortgages to homeowners who are at least 62 years old by absorbing virtually all risk associated with those loans. Lenders provide cash to homeowners in a single payment, a line of credit, or an annuity—secured by the equity in their homes. Under the HECM program, a borrower makes no payments for the life of the loan. Instead, interest accrues on the loan balance at the one-year Treasury rate plus 1.5 percent until the house is sold (by the borrower, surviving spouse, or estate of the owner), and the loan is paid off from the proceeds. FHA insurance protects lenders from the risk that the loan balance and interest will exceed the sale price of the home. FHA absorbs that risk in two ways: either by paying the lender any shortfall between the sale price and the amount due or by purchasing the mortgage from the lender when the loan balance reaches a specified limit. FHA also insures the borrower against failure by the lender to provide funds according to the agreement.

This option would increase FHA's fees and require borrowers to pay a portion up front. Raising the initial fee from 2 percent to 2.5 percent and collecting the 0.5 percentage-point increase in cash would increase federal offsetting collections (which are credited against discretionary spending) by $50 million in 2008 and by $272 million over five years, under an assumption that the program will continue to be authorized at 2007 levels.

FHA's losses are paid from premiums, which currently consist of a one-time charge of 2 percent of the value of the loan amount at the origination of the reverse mortgage and an annual fee of 0.5 percent of the current balance. On the basis of those fees and the outlook for interest rates and house prices, for every $100 of a loan that the program guarantees, FHA expects to earn between $1 and $2 over the life of the loan, on average. That is, the HECM program has a "negative" budget cost.

The main rationale for an increase in the HECM program's fees is to charge borrowers for some of the cost of risk now imposed on taxpayers. Losses or gains on the insurance are expected to vary with the overall state of the economy, including the uncertain future paths of interest rates and house prices. For example, according to estimates by Abt Associates, a 1 percentage-point increase in mortgage interest rates could convert the negative subsidy into a cost to the government of more than 2 percent of the amount insured (which, by the Congressional Budget Office's calculations, would shift a projected $54 million gain to a $111 million loss), while a 1 percentage-point decrease could result in a negative subsidy of 4 percent to 5 percent. An increase in fees might also encourage private lenders to increase the supply of reverse mortgages not guaranteed by FHA. At present, the agency insures over 90 percent of all reverse mortgages.

The primary disadvantage of increasing the HECM program's fees is that it would increase the cost of reverse mortgages to elderly homeowners, who tend to have greater wealth but less income than the general population. Moreover, higher fees could reduce the attractiveness of those mortgages, which allow the elderly to tap their home equity without selling their homes. Accordingly, the estimated budgetary effect shown here assumes a 10 percent decline in the level of insurance that FHA provides through the HECM program; a much larger decline could also result in a reduction rather than an increase in federal collections.

RELATED CBO PUBLICATIONS: *Assessing the Government's Costs for Mortgage Insurance Provided by the Federal Housing Administration,* July 19, 2006; and *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees,* August 2004

370-9—Discretionary

Impose Fees on the Small Business Administration's Secondary Market Guarantees

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-5	-5	-5	-6	-6	-27	-61
Outlays	-5	-5	-5	-6	-6	-27	-61

Through its 7(a) program, the Small Business Administration (SBA) guarantees 50 percent to 85 percent of the principal amount of qualifying loans to small businesses. Banks and other lenders often pool the guaranteed portions of such loans and then sell to investors trust certificates that represent claims to the cash flows. That is, the guaranteed portions of the loans are turned into tradable securities, or "securitized." Under authority provided in the Small Business Secondary Market Improvement Act of 1984, SBA provides a secondary guarantee of the trust certificates—guaranteeing timely payments on the certificates if the borrowers' payments are late. Consequently, through the Secondary Market Guarantee Program, SBA is taking on risk in addition to the initial guarantee of payment of the principal and interest in the event that borrowers default and the agency purchases the loans. That additional guarantee makes the securities more valuable to investors, who are, as a result, willing to pay more for them. Under current law, SBA charges no fee for the 100 percent secondary market guarantee.

This option would impose an annual charge of 10 basis points (10 cents per $100 of principal) on the outstanding guaranteed principal for SBA's new secondary market guarantees. On the basis of the loan volume reported by SBA for 2006, the proposed charge would increase federal offsetting collections (which are credited against discretionary spending) by $5 million in 2008 and by $27 million over five years.

The main advantage of this option is that it would provide SBA with funding to cover the cost of honoring secondary market guarantees. Specifically, when a borrower is late in making a loan payment, SBA makes the payment on schedule to the holders of the trust certificates, but in doing so, the agency incurs an interest expense for which it receives no offsetting revenues. To make those payments, SBA has drawn from funds intended for repayments of principal that must eventually be made to trust certificate holders, along with accrued interest. Thus, the Secondary Market Guarantee Program has a budgetary shortfall, which apparently derives from SBA's investment of deferred payments of principal to certificate holders in risk-free Treasury securities while those balances are accruing interest at the higher certificate rate. Another advantage of the option is that it would level the playing field with other federally guaranteed securities, such as those insured for timely payment by the Government National Mortgage Association, or Ginnie Mae, for which a fee is collected.

A disadvantage of this option is that it could decrease the attractiveness of SBA loans to lenders and thereby inhibit the flow of funds to small businesses.

RELATED CBO PUBLICATION: *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, August 2004

400

Transportation

Programs that support the interstate highway system, public transportation projects, aviation, railroads, and water transportation are funded mostly through the Department of Transportation, which distributes grants to state and local governments to help build and maintain transportation infrastructure. Funding for the federal-aid highway program constitutes about half of the budgetary resources for function 400, but substantial resources also go to air traffic control and Coast Guard operations. Aeronautics research sponsored by the National Aeronautics and Space Administration also is included in this category. The most significant recent change to function 400 was the establishment in 2003 of the Transportation Security Administration as part of the Department of Homeland Security.

The Congressional Budget Office (CBO) estimates that outlays for function 400 will total $75 billion in 2007, mostly for discretionary spending. The amounts of discretionary budget authority are much smaller than discretionary outlays, however, because many transportation programs are funded by contract authority (a mandatory form of budget authority) provided in authorizing legislation. Spending of that contract authority is controlled each year by obligation limitations set in appropriation bills.

Spending under function 400 has almost doubled since the early 1990s, largely because of substantial growth in outlays for the federal-aid highway program. Spending for surface transportation programs is authorized through 2009. The authorization for aviation programs expires in 2007, although CBO's baseline projections assume the Congress will enact legislation to extend those programs once they expire.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	23.4	26.6	23.6	25.5	28.7	26.1	5.3	-9.1
Outlays								
Discretionary	57.3	64.2	62.8	66.1	68.8	73.1	4.7	6.2
Mandatory	4.6	2.9	1.8	1.8	1.4	1.7	-25.2	19.4
Total	61.8	67.1	64.6	67.9	70.2	74.8	3.2	6.5

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 48 *Increase Excise Taxes on Motor Fuels by 50 Cents per Gallon*

Revenue Option 49 *Repeal the Partial Exemption for Alcohol Fuels from Excise Taxes*

Revenue Option 57 *Impose Fees on Users of the Inland Waterway System*

Revenue Option 61 *Impose Fees to Help Fund the Federal Railroad Administration's Rail-Safety Activities*

Revenue Option 62 *Increase Fees for Certificates and Registrations Issued by the Federal Aviation Administration*

400-1—Discretionary and Mandatory

Reduce Federal Aid for Highways

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Spending							
Budget authority	-11,282	-11,483	-11,696	-11,910	-12,123	-58,493	-122,515
Outlays	-3,046	-7,839	-9,899	-10,757	-11,404	-42,944	-105,255

Note: Budget authority includes mandatory contract authority. That contract authority is subject to obligation limitations set in appropriation acts; therefore, all outlays are considered discretionary.

The Federal-Aid Highway Program provides grants to states for highways and other surface transportation projects. When the Congress last reauthorized the program, in 2004, it substantially increased highway funding from levels provided in the previous authorization period. Funding for the Federal-Aid Highway Program is provided in the form of contract authority, a type of mandatory budget authority. However, most spending from the program is controlled by annual limits on obligations set in appropriation acts. Over the 1992–1997 period, those obligation limitations averaged about $18 billion per year; over the 1998–2003 period, they averaged nearly $28 billion.

This option would reduce spending for highways by lowering the obligation limitation for the Federal-Aid Highway Program in 2008 to, at most, $25 billion—the actual level set in 1997, adjusted for inflation. That cut would decrease budgetary resources for the program by more than 30 percent annually over the next 10 years. The option would also reduce contract authority for the program by a commensurate amount each year. Those changes would lower outlays by more than $3 billion in 2008 and by $43 billion through 2012. (In the budget, revenues from the federal gasoline tax are credited to the Highway Trust Fund to finance highway programs; this option would have no effect on gasoline tax rates.)

The principal rationale for this option is that it would shift more of the cost of building and maintaining highways to state and local governments. Some highway analysts argue that decisions about highway spending can be made more effectively at the state and local level—where most of the benefits accrue—than at the federal level. Moreover, federal highway spending can displace spending by state and local governments and, in some cases, by the private sector. The Government Accountability Office reported in 2004 that the existence of federal grants has tended to cause state and local governments to reduce their own spending on highways and allocate those funds for other uses. Further, federal funding allocations are not always directed toward uses that offer the greatest net benefits.

An argument against this option is that the nation may need additional highway capacity to meet the demand caused by growing levels of economic activity. In addition, some analysts argue that the federal government has a responsibility to pay for maintaining an adequate highway system to facilitate interstate commerce and to ensure certain standards of safety and quality for roads throughout the country.

RELATED CBO PUBLICATIONS: *Testimony on CBO's Projections of Revenues for the Highway Trust Fund*, April 4, 2006; *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998; and *Innovative Financing of Highways: An Analysis of Proposals*, January 1998

400-2—Discretionary

Eliminate the "New Starts" Transit Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-1,467	-1,493	-1,521	-1,548	-1,575	-7,604	-15,918
Outlays	-220	-664	-969	-1,207	-1,405	-4,466	-12,411

Under the "New Starts" program, the Department of Transportation provides funding for the construction of new rail and other "fixed-guideway" systems and for the expansion of existing systems. As defined by the program, fixed-guideway systems designate a separate right-of-way or rail line for the exclusive use of mass transportation. A related program, "Small Starts," provides discretionary grants for public transportation capital projects that cost less than $250 million and require less than $75 million in federal funding. Created in 2006 under the Safe Accountable Flexible Efficient Transportation Equity Act: A Legacy for Users, Small Starts was given an authorization of $200 million in annual appropriations. For 2007, the President proposed a total appropriation of $1.47 billion for both programs, of which $100 million was for Small Starts.

This option would eliminate the New Starts program, including Small Starts, saving more than $200 million in 2008 and almost $450 billion over the next five years.

One rationale for ending the program is that new rail transit systems tend to provide less value per dollar spent than bus systems do. Bus systems require much less capital and offer more flexibility when it is necessary to adjust schedules and routes to meet changing demands. Moreover, supporters of the option argue that letting the federal government dictate how communities should spend federal aid for transit is inappropriate and inefficient because local officials know their needs and priorities better than federal officials do. In addition, even without the New Starts program, state and local governments could still use federal aid distributed by formula grants (noncompetitive awards based on a predetermined formula) for new rail projects. In 2006, the federal government provided $6.9 billion in formula funding for transit projects, of which $1.4 billion was designated for the modernization of existing fixed-guideway systems and $3.8 billion (in broad "urbanized area" grants) was allocated for both existing and new systems.

A rationale against ending the New Starts program is that it seeks to identify the most promising rail transit projects from a long list of candidates. Supporters of rail transit assert that building additional roads does not alleviate urban congestion or pollution but leads only to greater decentralization and sprawl. New rail transit systems, by contrast, can help channel future commercial and residential development into corridors where public transportation is available, offering people easy and reliable access to their homes and the workplace.

400-3—Discretionary

Reduce the Federal Subsidy for Amtrak

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-204	-207	- 211	-215	-219	-1,056	-2,211
Outlays	-204	-207	- 211	-215	-219	-1,056	-2,211

When the Congress established the National Railroad Passenger Corporation—commonly known as Amtrak—in 1970, it anticipated providing subsidies for only a limited time, specifically until the railroad became self-supporting. After many years of providing federal subsidies, lawmakers in 1997 enacted the Amtrak Reform and Accountability Act, which directed the railroad to take a more businesslike approach to operations so that it would not need federal subsidies after 2002. For several years after that law was enacted, Amtrak reported to the Congress that it was on a "glide path" toward achieving operational self-sufficiency by the deadline. In the spring of 2002, however, it announced that it could not meet the deadline and that the goal of self-sufficiency was unrealistic. Amtrak has continued to receive federal subsidies annually, although the authorization for them expired at the end of 2002.

This option would reduce Amtrak's annual federal subsidy by $200 million in 2007 dollars, adjusted for inflation, yielding savings of $1.1 billion over five years. That size of reduction is illustrative, chosen on the basis of the financial gains the railroad could achieve by eliminating some particularly unprofitable routes and services. For example, the Department of Transportation's Inspector General estimates that eliminating sleeper-class services would help Amtrak attain cost savings—net of lost revenues from customers who would no longer travel by train if sleeper services were discontinued—of $75 million to $158 million annually. (Sleeper-class services include cars that accommodate overnight travelers, associated dining cars, onboard entertainment, lounge seating, checked baggage service, and food and beverage service.) Still larger savings could be realized by eliminating the five most unprofitable routes: according to Amtrak's Route Profitability System, those five routes accounted for combined annual losses of close to $250 million in recent years. The option does not specify any particular change in railroad operations, however, but instead leaves Amtrak's management free to decide how to adjust to the reduction in federal support.

Proponents of reducing subsidies generally favor having Amtrak function more like a business. They argue that it should cut routes and services that operate at a loss and focus instead on those that are in high demand and yield revenues that exceed costs. For example, only 16 percent of Amtrak's long-distance passengers use sleeper-class service. Given the cost of providing those amenities, per-passenger subsidies in 2004 for sleeper service ranged from $269 to $627, exceeding coach-service subsidies by at least 50 percent per route and by more than 100 percent in most cases. Similarly, cutting routes for which passenger revenues were not sufficient to cover operating costs would save funds and allow management to devote more attention to profitable routes. (If Amtrak's managers responded to reduced federal support by cutting such routes, travelers wouldn't necessarily be stranded: They could use alternative forms of transportation, or states could provide additional subsidies to keep routes operating.)

Opponents of reducing subsidies generally regard Amtrak as a public service that should be available on a nationwide basis. They maintain that passengers on lightly traveled routes have few transportation alternatives and that Amtrak is vital to the survival of small communities along those routes. Moreover, they say, improving service throughout the system could attract more passengers and make rail transportation more viable economically.

RELATED OPTIONS: 400-4, 400-5, and Revenue Option 61

RELATED CBO PUBLICATIONS: *The Past and Future of U.S. Passenger Rail Service*, September 2003; and *A Financial Analysis of H.R. 2329, the High-Speed Rail Investment Act of 2001*, September 25, 2001

400-4—Discretionary and Mandatory

Eliminate Grants to Large and Medium-Sized Hub Airports

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-1,245	-1,267	-1,290	-1,314	-1,337	-6,453	-13,509
Outlays	-237	-764	-1,051	-1,195	-1,291	-4,538	-11,416

Note: Budget authority is mandatory. Outlays are discretionary.

Under the Airport Improvement Program (AIP), the Federal Aviation Administration provides grants to airports to expand runways, improve safety and security, and make other capital investments. Between 1996 and 2006, about 40 percent of the program's funding went to airports classified, on the basis of the number of passenger boardings, as large and medium-sized hubs. Those hub airports—currently, there are about 70, though the number fluctuates from year to year—account for nearly 90 percent of boardings.

This option would eliminate the AIP's funding for large and medium-sized hub airports but would continue providing grants to smaller airports at levels consistent with those provided in 2006. In that year, smaller airports received about 65 percent of the $3.5 billion made available, or about $2.3 billion. Retaining only that portion of the program would reduce federal outlays by $237 million in 2008 and by $4.5 billion over the 2008–2012 period.

Funding for the AIP is subject to distinctive budgetary treatment. The program's budget authority is provided in authorization acts as contract authority, which is a mandatory form of budget authority. The spending of contract authority is subject to obligation limitations, which are contained in appropriation acts. Therefore, the resulting outlays are categorized as discretionary.

The main rationale for this option is that federal grants simply substitute for funds that larger airports could raise from private sources. Because those airports serve many passengers, they generally have been able to finance investments through bond issues as well as through passenger facility charges and other fees. Smaller airports may have more difficulty raising funds for capital improvements, although some have been successful in tapping the same sources of funding as their larger counterparts. By eliminating grants to larger airports, this option would focus federal spending on airports that appear to have the fewest alternative sources of funding.

A rationale against ending federal grants to large and medium-sized airports is that the grants could allow the Federal Aviation Administration to retain greater control over those airports by imposing conditions for aid. Such conditions could help ensure that the airports continued to make investment and operating decisions that would promote a safe and efficient aviation system.

RELATED OPTIONS: 400-3 and 400-5

RELATED CBO PUBLICATIONS: *Financing Small Commercial-Service Airports: Federal Policies and Options*, April 1999; and *The Economic Effects of Federal Spending on Infrastructure and Other Investments*, June 1998

400-5—Discretionary and Mandatory

Eliminate the Essential Air Service Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-110	-111	-112	-113	-114	-560	-1,150
Outlays	-88	-111	-112	-113	-114	-538	-1,128

Note: Under current law, the Essential Air Service Program receives both mandatory and discretionary budget authority.

The Essential Air Service program was created by the Airline Deregulation Act of 1978 to allow continued air service to communities that had received federally mandated service before deregulation. The program provides subsidies to air carriers serving small communities that meet certain criteria (such as being at least 70 miles from a large or medium-sized hub airport, except in Alaska and Hawaii, where separate rules apply). Those subsidies support air service to about 115 U.S. communities, including 3 in Hawaii and about 40 in Alaska. In 2005, the average subsidy per passenger ranged from $14 in Parkersburg, West Virginia, to $677 in Brookings, South Dakota. The Congress has directed that such subsidies not exceed $200 per passenger unless the community is more than 210 miles from the nearest large or medium-sized hub airport.

This option would eliminate the Essential Air Service program, reducing outlays by $88 million in 2008 and by $538 million over five years. (The President's 2007 budget proposed restructuring the program.)

One rationale for implementing this option is the high per-passenger cost of providing subsidized air transportation through the Essential Air Service program. Another is that the program was intended to be transitional, giving communities and airlines time to adjust to deregulation, more than a quarter of a century ago. Still another is that if states or communities derive benefits from air service to small communities, they could provide the subsidies themselves.

A rationale against eliminating the current program is that it alleviates the isolation of rural communities that otherwise would not receive air service. Because the availability of airline transportation is an important ingredient in the economic development of small communities, towns without the benefit of such service might lose a sizable portion of their economic base.

RELATED OPTIONS: 400-3, 400-4, and 400-6

400-6—Discretionary

Increase Fees for Aviation Security

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,290	-1,320	-1,370	-1,400	-1,450	-6,830	-14,760

The terrorist attacks of September 11, 2001, led to increased security measures at the nation's transportation facilities. One of the most sweeping changes resulted from the Aviation and Transportation Security Act of 2001, which made the federal government, rather than airlines and airports, responsible for screening passengers, carry-on luggage, and checked baggage. Implementing the new standards required that more-highly-qualified screeners be hired and trained, necessitating increased compensation and raising overall costs to the government.

To help pay for increased security, the law authorized airlines to charge passengers a fee of $2.50 each time they boarded a plane, capped at $5 for a one-way trip. The 2001 law also authorized the government to impose fees on the airlines themselves and to provide funding to reimburse airlines, airport operators, and service providers for the additional costs of their security enhancements. According to the Congressional Budget Office's estimates, the Transportation Security Administration (TSA) would collect about $2.7 billion from such fees in 2008—slightly more than half of the $4.8 billion in federal funding that would be needed that year to continue aviation security activities as currently authorized.

This option would increase fees so that they cover a greater portion of the federal government's spending for aviation security. Following changes to TSA's passenger fee structure proposed in the Administration's 2007 budget request, this option would replace existing passenger fees with a flat fee of $5 per one-way trip. Implementing the option would boost collections (and thus reduce net spending) by $1.3 billion in 2008 and by $6.8 billion through 2012. Under standard budgetary treatment, such collections would be classified as revenues, but because the Aviation and Transportation Security Act requires that revenues from the existing fees be recorded as offsets to federal spending, this option would treat the additional fees the same way.

The rationales for and against fully funding federal aviation-security measures by imposing fees rest on the principle that the beneficiaries of a publicly provided service should pay for it. The differences lie in who is seen as benefiting from such measures. A justification for the option is that the primary beneficiaries of transportation security enhancements are the users of the system. Security is viewed as a basic cost of airline transportation, in the same way that fuel and labor costs are. The current situation, in which those costs are covered partly by taxpayers in general and partly by users of the aviation system, provides a subsidy to air transportation.

Conversely, the rationale against higher fees is that the public in general—not just air travelers—benefits from improved airport security. To the extent that greater security reduces the risk of terrorist attacks, the entire population is better off. That reasoning suggests that the federal government should fund the enhanced transportation security measures without collecting additional funds directly from the airline industry or its customers.

RELATED OPTIONS: 400-5 and Revenue Option 62

400-7—Discretionary or Mandatory

Impose Fees on Users of the St. Lawrence Seaway

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-8	-17	-17	-17	-18	-77	-169

Note: This fee could be classified as an offsetting collection (discretionary) or as an offsetting receipt (usually mandatory), depending on the specific language of the legislation establishing the fee.

The St. Lawrence Seaway Development Corporation (SLSDC) was established in 1954 to operate and maintain the portion of the St. Lawrence Seaway controlled by the United States between the Port of Montreal and Lake Erie. The SLSDC, a federal agency within the Department of Transportation, collected commercial tolls to fund operation and maintenance costs from 1959 until the establishment of the harbor-maintenance tax in the Water Resources Development Act of 1986. Revenues from the tax, which is levied on imports and domestic shipments at Great Lakes and coastal ports, are credited to the Harbor Maintenance Trust Fund (HMTF). An appropriation from the HMTF currently funds operation and maintenance costs on the seaway.

This option would reestablish commercial tolls on the portion of the St. Lawrence Seaway governed by the United States to cover operation and maintenance costs incurred by the SLSDC. It also would terminate appropriations from the HTMF. By reestablishing such a fee, the SLSDC would operate in the same manner as its Canadian counterpart, the St. Lawrence Seaway Management Corporation, which already charges commercial tolls on the Canadian portion of the seaway. Those changes would generate receipts of $8 million in 2008 and $77 million over the 2008–2012 period.

The main rationale for this option is that users would be required to pay the SLSDC directly for the services they use. In particular, exporters—which are subsidized under the current system—would be put on an equal footing with importers and domestic shippers. The option's businesslike approach would give all users incentive to economize on their use of seaway services, thus improving efficiency.

A rationale against reintroducing such fees is that tolls could harm the Great Lakes shipping industry, particularly exporters, who currently are not taxed for their use of the United States' portion of the seaway. Certain importers and shippers of domestic goods that already contribute to operation and maintenance costs through the harbor-maintenance tax might be required to pay additional fees. The application of the harbor-maintenance tax on those users of Great Lakes ports could be repealed to avoid duplicative charges but doing so would reduce or eliminate the option's savings.

RELATED OPTIONS: 300-1 and Revenue Options 57 and 62

RELATED CBO PUBLICATION: *Paying for Highways, Airways, and Waterways: How Can Users Be Charged?* May 1992

450

Community and Regional Development

The federal government funds programs that promote the economic viability of communities, encourage rural development, and assist in the nation's disaster preparedness and response. Function 450 includes funding for flood insurance and disaster relief, homeland security grants to pay state and local governments' first responders, the Community Development Block Grant program, credit assistance to rural communities, and programs that assist Native Americans.

Federal spending for community and regional development projects has risen substantially since the terrorist attacks of September 11, 2001, as lawmakers increased funding for recovery efforts and for grants to state and local first responders. About $60 billion was appropriated in this function for relief and reconstruction in the aftermath of the Gulf Coast hurricanes of 2005. In 2006, more than $20 billion in borrowing authority was provided to the National Flood Insurance Program to pay resulting claims. Because spending for hurricane relief is declining, outlays for function 450 are expected to total about $28 billion in 2007. Although that is about half the total for 2006, it still represents an increase of more than 100 percent since 2002.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

	2002	2003	2004	2005	2006	Estimate 2007[a]	Average Annual Rate of Growth (Percent) 2002-2006	2006-2007
Discretionary Budget Authority	22.7	16.4	17.4	82.4	14.0	13.0	-11.3	-7.8
Outlays								
Discretionary	14.1	19.5	15.7	24.9	38.3	25.7	28.3	-32.9
Mandatory	-1.2	-0.6	0.2	1.3	16.2	2.6	n.a.	-84.2
Total	13.0	18.9	15.8	26.3	54.5	28.3	43.2	-48.1

Note: n.a. = not applicable (because of a negative value in the first or last year).

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

450-1—Discretionary

Drop Wealthier Communities from the Community Development Block Grant Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-553	-562	-573	-583	-593	-2,864	-5,994
Outlays	-11	-155	-445	-541	-562	-1,714	-4,710

The Community Development Block Grant (CDBG) program provides annual grants to communities to help them aid low- and moderate-income households, eliminate slums and blight, or meet emergency needs by rehabilitating housing, improving infrastructure, and carrying out economic development activities. Part of the program—referred to as the entitlement component—makes grants directly to cities and urban counties. (The program also allocates funds to states, which distribute them to smaller and more-rural communities—called nonentitlement areas—typically through a competitive process.) Funds from the entitlement component may also be used to repay bonds that are issued by local governments and guaranteed by the federal government under the Section 108 loan guarantee program. For 2006, the CDBG program received an appropriation of $3.7 billion, including $2.6 billion for entitlement communities.

Under current law, the CDBG entitlement program is open to all urban counties, principal cities of metropolitan areas, and cities with a population of at least 50,000. The program allocates funding according to a formula based on the community's population, the number of residents with income below the poverty line, the number of housing units with more than one person per room, the number of housing units built before 1940, and the extent to which population growth since 1960 is less than the average for all metropolitan cities. The formula does not require that a certain percentage of residents have income below the poverty line, nor does it exclude communities with high average income. A 2003 analysis from the Department of Housing and Urban Development, which administers the CDBG program, showed that funding under the formula shifted from poorer to wealthier communities, as measured by average poverty rates, when population data and other information were updated using results from the 2000 census.

This option would focus CDBG entitlement grants on needier areas and reduce funding accordingly. The option could be implemented in a variety of ways, but one simple approach would be to exclude communities whose per capita income exceeded the national average by more than a certain percentage. For example, restricting the grants to communities whose per capita income was less than 110 percent of the national average would reduce entitlement funds by 21 percent. To illustrate the general approach, this option would make a slightly smaller cut of 20 percent, which would save $1.7 billion over five years. (The Administration offered a proposal in 2006 to improve the formula's targeting of needy communities through a different set of changes. The proposal also included eliminating entitlement grants to communities whose formula allocation is relatively small—specifically, less than 0.014 percent of the total for all communities.)

One argument for narrowing eligibility for entitlement grants is that doing so would reduce the size of a program that should not exist at all because using federal funds for local development is never appropriate. An alternative argument is that even if the CDBG program can be justified because of its redistributive effects, redirecting money to wealthier communities serves no pressing interest.

The main argument against this option is that dropping wealthier communities from the CDBG program could reduce efforts to aid low-income households within those communities, unless local governments reallocated their own funds to offset the lost grants.

RELATED OPTIONS: 450-2 and 450-3

450-2—Discretionary

Eliminate the Neighborhood Reinvestment Corporation

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-119	-121	-124	-126	-128	-618	-1,293
Outlays	-119	-121	-124	-126	-128	-618	-1,293

The Neighborhood Reinvestment Corporation (NRC) is a public, nonprofit organization charged with revitalizing distressed neighborhoods. The NRC oversees a network of locally initiated and operated groups called NeighborWorks Organizations (NWOs), which engage in a variety of housing, neighborhood-revitalization, and community-building activities. The corporation provides technical and financial aid to new NWOs and monitors and assists those already established. The NeighborWorks network includes over 230 member organizations operating in more than 4,400 communities nationwide. Congressional appropriations account for roughly 90 percent of the corporation's operating funds; for 2006, the NRC's appropriation was $117 million.

Under this option, the Neighborhood Reinvestment Corporation would be eliminated, saving $119 million in 2008 and $618 million over five years.

The NRC uses its funds to provide grants, conduct training programs and educational forums, and produce publications in support of NeighborWorks Organizations. The bulk of its grant money goes to NWOs, which use it to purchase, construct, and rehabilitate properties; capitalize revolving-loan funds; develop new programs; and cover operating costs. NWOs' revolving-loan funds make mortgage and home improvement loans to individuals as well as loans to owners of mixed-use properties who provide long-term rental housing for low- and moderate-income people. In addition, the NRC awards grants to Neighborhood Housing Services of America, which provides a secondary market for the loans made by NWOs.

One rationale for eliminating the NRC is that the federal government should not fund programs whose benefits are not national in scope. In addition, the NeighborWorks approach duplicates the efforts of other federal programs—particularly those of the Department of Housing and Urban Development (HUD)—that also rehabilitate low-income housing and promote home ownership and community development. Moreover, the NRC is a relatively minor source of funding for NeighborWorks organizations. In 2003, its grants accounted for less than 20 percent of NWOs' funding from government sources and less than 5 percent of their total funding. Larger shares came from private lenders, foundations, corporations, and HUD.

An argument against this option is that the large number of federal programs that exist to assist local development is evidence of widespread support for a federal role, particularly in areas where state and local governments lack adequate resources of their own. Furthermore, NWOs address problems in whole neighborhoods rather than individual properties. And, with their nonhousing activities (such as community-organization building, neighborhood cleanup and beautification, and leadership development), they provide economic and social benefits that other federal programs do not. Finally, the NRC may be particularly valuable because it has flexibility in making grants—which allows it to fund worthwhile efforts that do not fit within the narrow criteria of larger federal grantors—and because it provides the NWOs with needed training, program evaluation, and technical assistance.

RELATED OPTIONS: 450-1 and 450-3

450-3—Discretionary

Eliminate the Community Development Financial Institutions Fund

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-32	-40	-41	-42	-43	-198	-426
Outlays	-6	-37	-39	-41	-42	-165	-385

The Community Development Financial Institutions (CDFI) Fund was created in 1994 to expand the availability of credit, investment capital, and financial services in distressed communities. Administered by the Treasury Department, the fund provides equity investments, grants, loans, and technical assistance to CDFIs, which include community development banks, credit unions, loan funds, venture capital funds, and microenterprise funds. In turn, those institutions provide a range of financial services—such as mortgage financing for first-time home buyers, loans and investments for new or expanding small businesses, and credit counseling—in markets that are underserved by traditional institutions. The CDFI Fund also provides incentive grants to traditional banks and thrift institutions to invest in CDFIs and to increase loans and services to distressed communities. In addition, the fund administers the New Markets Tax Credit (NMTC) program begun in 2002 to provide federal tax credits for qualified investments in "community development entities." The CDFI Fund received appropriations of $54 million in 2006.

This option would eliminate the CDFI Fund, reducing discretionary outlays by a total of $165 million through 2012. That estimate of savings takes into account the small amount of additional spending that would be required by other agencies to oversee the fund's existing loan portfolio and administer the NMTC program.

One rationale for eliminating the CDFI Fund is that local development should be financed at the state or local level, not by the federal government, because its benefits are not national in scope. Another argument is that the fund is redundant. Many other federal agencies and programs—including the housing loan programs of the Rural Housing Service, the Community Development Block Grant program, the Neighborhood Reinvestment Corporation, and the Economic Development Administration—support home ownership and local economic development. Those agencies and programs received appropriations of $21.5 billion in 2006, including supplemental appropriations of $16.7 billion to assist with recovery efforts related to Hurricane Katrina. Furthermore, assistance to CDFIs may be inefficient because it encourages loans that would otherwise not pass market tests for creditworthiness.

The primary argument against eliminating the CDFI Fund is that the federal government has a legitimate role in assisting needy communities, some of which lack access to traditional sources of credit. By helping existing CDFIs and stimulating the creation of others, the fund may provide an effective mechanism for leveraging private-sector investment with a relatively small federal contribution.

RELATED OPTIONS: 450-1 and 450-2

450-4—Discretionary

Convert the Rural Community Advancement Program to State Revolving Funds

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	0	-13	-26	-40	-53	-133	-4,204
Outlays	0	-1	-5	-12	-23	-41	-2,219

The Department of Agriculture's Rural Community Advancement Program (RCAP) helps rural communities by providing loans, loan guarantees, and grants for water, waste-disposal, and waste-management projects; community facilities; and various activities designed to promote economic development. The program received discretionary appropriations of roughly $718 million in 2006 for grants and for the budgetary cost of its loans and loan guarantees. (That cost is defined under credit reform as the present value of interest rate subsidies and expected defaults on the loans and guarantees.)

RCAP funds are generally allocated among states on the basis of their rural populations and the number of rural families with income below the poverty level. Within each state's allocation, the Department of Agriculture awards funds on a competitive basis to eligible applicants, including state and local agencies, nonprofit organizations, and (in the case of loan guarantees for business and industry) for-profit companies. The terms of a recipient's assistance depend on the purpose of the aid and, in some instances, on economic conditions in the recipient's area. For example, aid for water and waste-disposal projects can take the form of loans with interest rates ranging from 4.5 percent to market rates depending on the area's median household income. Areas that are particularly needy may receive grants or a mix of grants and loans.

This option would reduce future federal spending by providing money to capitalize state revolving funds for rural development and then ending federal assistance under RCAP. The amount of federal savings would depend on the level and timing of the contribution that capitalized the revolving funds. Under one illustrative approach, the federal government would provide funding of $718 million annually for five years to capitalize the funds and then cut off assistance in 2013. That approach would yield modest savings ($41 million) over five years but more-significant savings ($2.2 billion) through 2017. However, that level of capitalization would not by itself support the volume of loans and grants that RCAP now provides. Accordingly, the Congress could allow the revolving funds to use their capital as collateral to leverage additional financing from the private sector, as the state revolving funds established under the Clean Water Act and the Safe Drinking Water Act have been allowed to do.

The rationale for cutting off RCAP funding is that the federal government should not bear continuing responsibility for local development; rather, programs that benefit localities, whether urban or rural, should be funded at the state or local level. The rationale for the specific approach taken in this option is that a few years of federal funding to capitalize the revolving funds will provide a reasonable transition to the new policy.

One argument against converting RCAP to revolving funds is that states might change their types of aid (substituting loans for grants and high-interest loans for low-interest loans) to avoid depleting the funds and to recoup the costs of any leveraged financing. Such a change could price the aid out of reach of needier communities. In addition, the estimated federal savings might not materialize: for example, the Congress has appropriated additional grants to state funds for wastewater treatment systems after expiration of the original authorization for those grants. Moreover, the component of RCAP that receives the majority of the funds, the program for water loans and grants, has been judged to be "effective" by the Office of Management and Budget.

450

RELATED OPTION: 300-9

450-5—Discretionary

Eliminate Region-Specific Development Agencies

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-50	-51	-52	-53	-54	-260	-542
Outlays	-11	-23	-37	-46	-52	-169	-461

The federal government provides annual funding to three regional development agencies: the Appalachian Regional Commission (ARC), the Denali Commission, and the Delta Regional Authority. The ARC, established in 1965, conducts activities that promote economic growth in the Appalachian counties of 13 states, stretching from southern New York to northern Mississippi. Modeled after the ARC, the Denali Commission, which was created in 1998, covers remote areas in Alaska. Similarly, the Delta Regional Authority, established in 2000, covers 240 counties and parishes near the Mississippi River in eight states, stretching from southern Illinois to the Louisiana coast. For 2007, the Congress appropriated $65 million for the ARC, $51 million for the Denali Commission, and $12 million for the Delta Regional Authority.

This option would discontinue federal funding for the Appalachian, Denali, and Delta regional development agencies. That change would reduce discretionary outlays by $11 million in 2008 and by $169 million over five years.

The three agencies provide programs that are intended, among other things, to create jobs, improve rural education and health care, develop utilities and other infrastructure, and provide job training. However, it is difficult to assess whether such outcomes can be attributed to those programs, to other governmental and nongovernmental organizations, or to the effects of general economic conditions.

An argument for ending federal funding of the three agencies is that such action would shift more responsibility for supporting local or regional development to the states and localities whose citizens would benefit from that development. Another rationale for the option is that needy areas exist throughout the country; therefore, Appalachia, rural Alaska, and the Mississippi Delta should have no special claim to federal dollars. In that view, any federal development aid they do receive should come from nationwide programs, such as those overseen by the Economic Development Administration, rather than from federal programs that focus on specific regions.

The main arguments against this option are that the federal government has a legitimate role to play in redistributing funds among states to support development in the neediest areas and that cutting federal funding would reduce local progress in education, health care, and job creation. Another argument is that Appalachia, rural Alaska, and the Mississippi Delta merit special attention because of the extent of poverty that exists in those regions. An additional argument against eliminating the Delta Regional Authority is that there is an added need for established organizations to help with the redevelopment effort in the Mississippi Delta following the devastation caused by Hurricanes Katrina and Rita.

450-6—Discretionary

Restrict First-Responder Grants to High-Risk Communities

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-223	-227	-231	-235	-239	-1,155	-2,419
Outlays	-68	-151	-208	-227	-231	-885	-2,104

The Department of Homeland Security (DHS) issues grants to local governments to help police, firefighters, and other first responders prepare for terrorist attacks—by, for example, receiving biohazard training, acquiring special equipment (such as chemical suits), and providing additional physical security for critical infrastructure. For 2007, the Congress appropriated about $2.5 billion for homeland security grants, which are administered by DHS's Preparedness Directorate. Of the amounts appropriated for 2007, $875 million will be distributed through the State Homeland Security Grant Program and the Law Enforcement Terrorism Prevention Program using a formula that guarantees that no state will receive less than 0.75 percent of the appropriation. That approach may not fully reflect certain communities' potential attractiveness as terrorist targets or the scale of prospective human and economic loss from an attack.

This option would have three components: eliminating the practice of allocating first-responder grants by formula, cutting 25 percent of the funds that are now distributed that way, and directing DHS to allocate the remaining 75 percent using criteria that reflect risk and the effectiveness of the proposed uses of the grants. DHS already uses such criteria to allocate discretionary first-responder grants, such as those in the Urban Areas Security Initiative. The option would save $68 million in 2008 and $885 million over five years.

Proponents of eliminating formula-based funding argue that many grants now go to communities with small and dispersed populations, little critical economic activity, or few evident targets for terrorists. Those communities may be less likely to be attacked and, if they were, would incur relatively small losses. Supporters of altering the formula also point out that not all the money currently available has been spent: as of September 31, 2006, more than $5 billion in prior-year funding had not yet been disbursed. And, according to some observers, the dollars that were spent yielded little increase in national security, either because much of the spending did not enhance emergency preparedness or because it simply replaced other sources of funding for ongoing preparedness efforts.

Opponents of changing the current allocation note that DHS already provides funds for other security programs (such as those at airports, seaports, and other transportation centers) that selectively benefit communities where risks of attack and losses may be greater. In addition, federal regulatory programs and private businesses are working to help protect prime targets in those at-risk communities. Thus, opponents of this option argue, continuing to issue first-responder grants on the basis of geography may help restore balance in the allocation of funding. Moreover, terrorism is only one of many risks that communities face. Preparations nominally intended to deal with terrorist attacks may help mitigate the costs of crime, fires, storms, floods, or earthquakes—threats that exist everywhere. Advocates of that view support legislation that would broaden the uses for DHS's first-responder grants to include preparations for all types of disasters.

RELATED CBO PUBLICATIONS: *Federal Terrorism Reinsurance: An Update*, January 2005; *Homeland Security and the Private Sector*, December 2004; and *Federal Funding for Homeland Security*, April 30, 2004

450-7—Discretionary

Impose a Time Limit on the Subsidy on Disaster Loans from the Small Business Administration

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-24	-24	-25	-25	-25	-124	-256
Outlays	-12	-22	-25	-25	-25	-109	-244

The Small Business Administration (SBA) provides low-interest loans to households, businesses, and nonprofit organizations that have suffered losses in events declared disasters by the President. With some exceptions, the loans can be used to replace personal property or business machinery, equipment, and inventory; to repair or restore damaged homes or business structures; to provide operating funds while a business recovers; and for certain other purposes. SBA sets the duration of each loan on a case-by-case basis, according to the borrower's ability to repay. The interest rate on loans to recipients who can obtain credit elsewhere is based on the federal government's borrowing cost (but is capped at 8 percent); other recipients pay interest at half that rate.

This option, consistent with a proposal included in the President's budget for 2007, would limit the interest subsidy on all new disaster loans offered by the SBA to the first five years after origination, with the rate increasing thereafter to reflect the rate the Treasury pays to borrow money for a similar length of time. The option would save $12 million in 2008 and $109 million over five years. (Budgetary savings would occur immediately because, under the Federal Credit Reform Act, the budgetary cost of a loan is incurred at origination and is calculated as the present value of the loan's expected subsidy cost and default risk.)

The argument for imposing such a time limit on the subsidy on disaster loans is that five years is adequate time for disaster victims' finances to stabilize, so by that point, the recipients have no special claim on federal aid. The argument against the time limit is that, in many cases, borrowers' losses still represent significant reductions in their wealth after five years, even if their current finances have stabilized. The fact that SBA sets a repayment period longer than five years for a given loan indicates that the repayment is expected to continue to pose a financial burden.

RELATED CBO PUBLICATION: *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees*, August 2004

450-8—Mandatory

Eliminate or Reduce the Flood Insurance Subsidy on Certain Older Structures

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	0	0	0	0	0

Note: Net budgetary savings would be zero under current law because the National Flood Insurance Program would spend increased income from premiums to pay claims that otherwise would accumulate as unpaid obligations.

The National Flood Insurance Program (NFIP) charges two different sets of premiums to insure buildings and their contents. One set applies to structures built either before 1975 or before the completion of a community's official flood insurance rate map (FIRM). Those structures are classified as "pre-FIRM." The other set of premiums applies to "post-FIRM" structures. Post-FIRM premiums are intended to be actuarially sound (that is, to cover the costs of all insured losses over the long term). They are based on a building's elevation relative to the flood level that is thought to have a 1 percent chance of being equaled or exceeded each year in that location. Pre-FIRM rates, by contrast, are heavily subsidized, on average, and do not take into account a building's elevation.

The Federal Emergency Management Agency (FEMA), which administers the flood insurance program, estimates that 26 percent of such policies are priced at subsidized rates. The subsidies are available only for the first $35,000 of coverage on a one- to four-family dwelling and for the first $100,000 of coverage on a larger multifamily residential, nonresidential, or small-business building. Various levels of additional coverage are available at actuarially sound rates. Taking both the subsidized and unsubsidized tiers into account, FEMA estimates that the average subsidies for both buildings and contents amount to roughly 60 percent—that is, premiums represent 40 percent of the actuarial value of the insurance. (The subsidy for a particular building can vary greatly from the average, however, depending on the building's elevation.)

One way to reduce the cost of the subsidy would be to phase it out over five years. That change would increase the program's premium income by about $2 billion over the 2008–2012 period. Those estimates take into account the likelihood that some current policyholders would drop their coverage in the absence of the current subsidy. (Carrying flood insurance is voluntary in some cases; and even where it is required, compliance is far from complete.) Alternatively, smaller reductions in program costs could be realized by phasing out the subsidy on all insured pre-FIRM structures other than primary residences—in other words, on second and vacation homes, rental properties, and nonresidential buildings—or by eliminating the subsidy on all new policies, including those purchased by new owners after properties are sold. However, none of the approaches would lead to any net budgetary savings, the Congressional Budget Office estimates. Currently, the program must use nearly half of its annual income from premiums to pay debt-service costs on the $17 billion it has borrowed (to date) to pay claims resulting from the Gulf Coast hurricanes of 2005. The remaining half is not enough to cover the average annual cost of future claims. Thus, under current law, the effect of the additional receipts generated by the option would be to allow the NFIP to pay claims that it otherwise would lack the resources to pay, and the benefit would go not to the federal Treasury but to flood-insurance policyholders.

Proponents of eliminating the subsidy on at least some pre-FIRM structures argue that the subsidy has outlived its original justification: to serve as a temporary incentive to encourage participation among property owners who were not previously aware of the magnitude of the flood risks they faced. According to that view, charging actuarial rates on pre-FIRM properties would make those policyholders pay their fair share for insurance protection; it would also give them appropriate incentives to relocate or take preventive measures.

One general argument for maintaining the subsidy is that charging full actuarial rates for properties built before FEMA documented the extent of local flood hazards is unfair. A second such argument is that actuarial rates would be very high in some cases—as much as ten times the current subsidized rates—posing financial hardships to some property owners and reducing property values in

some communities. Also, actuarial premiums that reduced participation in the program could lead to greater spending on federal disaster grants and loans, thus eroding some of the projected savings.

Other arguments—both for and against eliminating the subsidy—focus on particular sets of properties. An advantage of phasing out the subsidies on all pre-FIRM properties is that doing so ultimately would make the program actuarially sound, thereby helping the most to reduce the need for future loans from the general Treasury like those required in the aftermath of Hurricanes Katrina and Rita in 2005. (Because of the built-in subsidies, the NFIP never accumulated reserves for such catastrophic events and is unlikely ever to be able to repay those loans.)

By contrast, keeping the subsidies for primary residences could be justified as improving the program's financial position to some degree while focusing the remaining subsidies on structures whose owners might face the greatest hardship in paying actuarial rates. Opponents of that approach note, however, that ending subsidies for rental properties might cause owners to pass on increased costs to renters.

Finally, an argument for limiting the subsidy-elimination effort to new policies is that purchasers are now well aware of the dangers posed by floods, whether their properties are pre-FIRM or post-FIRM. Again, however, some of the general arguments against eliminating any pre-FIRM subsidies can be made: Large increases in flood insurance premiums could lead to financial hardship for some property owners, reduced property values for some communities, and increased federal costs for disaster assistance.

RELATED CBO PUBLICATION: *Testimony on the Budgetary Treatment of Subsidies in the National Flood Insurance Program*, January 25, 2006

450-9—Mandatory

Reduce the Expense Allowance Retained by Private Insurance Companies in the National Flood Insurance Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	0	0	0	0	0

Note: Net budgetary savings would be zero under current law because the National Flood Insurance Program would use the funds not spent on the expense allowance to pay claims that otherwise would accumulate as unpaid obligations.

Almost all policies sold in the National Flood Insurance Program (NFIP) are issued and administered by private insurance companies that participate in the NFIP's Write Your Own (WYO) program. Begun in 1983, the program is designed to increase the number of NFIP policies sold, improve service to policyholders, and provide the insurance industry with direct experience handling flood insurance. The WYO companies act as agents for the NFIP, which determines premium rates and underwriting rules and bears sole responsibility for paying claims. Participating companies are allowed to retain a share of the premiums they collect as an expense allowance; that share—currently 30.2 percent—is determined annually by the Federal Emergency Management Agency (FEMA) on the basis of industry expense data for similar lines of insurance (such as fire and homeowners multiple peril) as reported by A.M. Best. Also, when policyholders incur losses that are covered, the companies receive additional compensation equal to 3.3 percent of the value of the claims they handle. As of November 2006, FEMA's Web site listed 86 companies participating in the program.

This option would direct FEMA to reduce the WYO expense allowance by 1 percentage point while leaving policyholder premiums unchanged. Such action would increase receipts by $26 million in 2008 and by $137 million over five years. (Option 350-4 discusses a similar change to the Department of Agriculture's crop insurance program.) However, the increase in receipts would not lead to any net budgetary savings, the Congressional Budget Office estimates. Currently, the program must use nearly half of its annual premium income to pay debt service on the $17 billion it has borrowed (to date) to pay claims resulting from the Gulf Coast hurricanes of 2005, and the remaining half is not enough to cover the average annual cost of future claims. Thus, under current law, the effect of the additional receipts generated by the option would be to allow the NFIP to pay claims that it otherwise would lack the resources to pay, and the benefit would go not to the federal Treasury but to flood insurance policyholders.

The main argument in favor of reducing the expense allowance is that the A.M. Best data used by FEMA to calculate the expense allowance may yield overestimates of the costs that the companies incur as a result of selling NFIP policies. The traditional insurance industry practice of compensating agents in proportion to the dollar value of the policies they sell seems to reflect costs in an approximate, average way at best. For example, differences in elevation (relative to the water level expected in a "100-year flood") can make the insurance premium on one property much higher than that on a second property that otherwise is identical, but such differences do not affect the amount of time involved in selling the coverage. Moreover, even within the traditional percentage-of-premium approach, the A.M. Best data may overstate WYO costs: Because most flood insurance is sold in conjunction with other policies (such as homeowners insurance), advertising and other marketing costs are minimal. The fact that participation in the Write Your Own program is so widespread suggests that FEMA may have room to reduce the expense rate. Also, reducing the expense allowance while leaving the premiums unchanged would slightly reduce the structural deficit built into the NFIP by the subsidized rates charged on older buildings (see Option 450-8).

The main argument against the option is that it could lead to the sale of fewer NFIP policies: If insurers did not receive adequate compensation for their costs, they might drop out of the program; and some potential purchasers who were no longer able to buy flood insurance from the same agent who sold them other coverage might not make the additional effort to find a second source. The option could also lead to an increase in FEMA's own

administrative expenses if the number of policies sold by the agency itself increased. Alternatively, if the participating companies truly have been overpaid, then policyholders insured at full-rate premiums have been paying too much for their coverage, and the benefit of reducing the expense allowance on their policies should be passed on to them in the form of reduced premiums, not retained by the NFIP. To the extent that the NFIP's structural deficit is a problem, it could be addressed more directly by reducing or eliminating the subsidies rather than through hidden cross-subsidies from policyholders who pay full-rate premiums.

RELATED OPTIONS: 350-4 and 450-8

500

Education, Training, Employment, and Social Services

Programs of the Departments of Education, Labor, and Health and Human Services provide—or assist states and localities in providing—a variety of services to individuals. Those activities include developmental services for children in low-income families, programs for elementary and secondary school students, grants and loans for postsecondary students, and general job-training and employment services.

Outlays for function 500 will total about $92 billion in 2007, the Congressional Budget Office estimates, of which about $80 billion will be discretionary spending. Between 2002 and 2006, discretionary outlays increased by about 6.3 percent per year; little growth in spending is projected for 2007. Education spending consumes about 70 percent of the function's discretionary outlays.

Mandatory spending in function 500 is primarily for higher-education loan subsidies, the Social Services Block Grant program, and rehabilitation services and disability research. Mandatory spending varies greatly from year to year because of changes in loan volume (especially for consolidation loans), interest rates, revisions to previous estimates of subsidy costs, and other factors that affect the federal student loan programs. The large increase in outlays in 2006 reflects several of those factors.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	71.3	75.1	78.2	80.2	80.3	80.3	3.0	*
Outlays								
Discretionary	62.8	71.3	75.2	79.1	80.3	80.4	6.3	0.1
Mandatory	7.8	11.3	12.8	18.4	38.4	11.9	48.9	-69.1
Total	70.6	82.6	88.0	97.6	118.7	92.2	13.9	-22.3

Note: * = between -0.1 percent and zero.

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 22 *Consolidate Tax Credits and Deductions for Education Expenses*

500-1—Discretionary

Reduce Funding to School Districts for Impact Aid

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-131	-134	-136	-139	-141	-681	-1,426
Outlays	-116	-123	-130	-137	-141	-646	-1,388

The Impact Aid program, authorized under title VIII of the Elementary and Secondary Education Act, provides money to school districts that are financially burdened, for example, by the presence of military bases or Indian lands within the district. Those tracts of land have a financial impact because the district receives no property taxes from them yet is obliged to provide a free public education to the so-called federally connected students who live on them.

In 2007, approximately 1,300 local educational agencies will receive basic support payments from the Impact Aid program. For a school district to be eligible for those payments, a minimum of 3 percent—or at least 400—of its schoolchildren must be associated with activities of the federal government. How much money a school district receives is based on a formula that adds up the number of federally connected students in the district's population and then applies a weight to each that roughly indicates the impact of that student on the school district's revenues. For example, students who live on Indian lands receive a weight of 1.25, and those who live on federal land within the school district with a parent employed on federal land or on active duty in the uniformed services receive a weight of 1.0. A number of categories of federally connected students are assigned smaller weights. For instance, students from military families who live in off-base housing receive a weight of 0.2. Other students who have a parent employed on federal land within the same state are assigned a smaller weight. However, school districts do not receive payments for those categories of federally connected students unless they enroll at least 1,000 such students (or those students equal 10 percent of the district's total enrollment).

This option would focus Impact Aid on the school districts that federal activities most strongly affect by basing support payments solely on a district's enrollment of students who are assigned weights of 1.0 or greater. Eliminating support for students who are assigned smaller weights would reduce federal outlays by $116 million in 2008 and by $646 million from 2008 to 2012.

A rationale for this option is the appropriateness of paying Impact Aid only for students whose presence puts the greatest burden on school districts. An argument against the option is that eliminating payments for other types of students who are associated with activities of the federal government could significantly harm certain districts—for example, those in which large numbers of military families live in off-base housing but shop at military exchanges, which do not collect local sales taxes.

500-2—Discretionary

Eliminate Grants to the States for Safe and Drug-Free Schools and Communities

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-353	-359	-366	-372	-379	-1,830	-3,831
Outlays	-7	-212	-322	-363	-369	-1,273	-3,222

Grants to the states under the Safe and Drug-Free Schools and Communities Act (SDFSCA) support programs to discourage violence and the use of illegal substances—such as alcohol, cigarettes, and drugs—among young people in and around schools. States receive SDFSCA funding on the basis of their school-age population and number of poor children. In 2006, that funding totaled $346.5 million.

States distribute SDFSCA funds to school districts in the form of grants that must be used according to certain guidelines. Although the SDFSCA program stipulates that 93 percent of the funds states receive must go toward activities that address violence and drug abuse in schools, it offers little guidance about what constitutes an effective use of those funds.

This option, like the President's budget request for 2007, would eliminate payments to states under the SDFSCA, reducing federal outlays by $7 million in 2008 and by a total of about $1.3 billion through 2012.

An argument for cutting SDFSCA funding is that several evaluations of various programs supported by state grants have demonstrated that the programs do not reduce the incidence of violence and drug abuse at school. Furthermore, although violence and drug abuse in general are pressing societal issues, they are problems that rarely occur on school grounds. Despite the occasional well-publicized incident, studies show that children are more likely to be victims of violence or homicide while away from school, and drug abuse occurs infrequently on school property, although it is more widespread than violent crime.

An argument against this option is that individual efforts funded under the SDFSCA may serve a critical function by raising the public's awareness of the problems of drug abuse and violence. In addition, some prevention programs supported by SDFSCA grants have been successful in reducing drug abuse. If funding for such programs was eliminated, drug use and violence might accelerate and lead to even more costly interventions on the part of school systems and communities.

500-3—Discretionary

Fund the Federal Goal of Paying 40 Percent of the Added Cost of Educating a Disabled Child

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	+14,912	+15,477	+16,028	+16,536	+17,048	+80,002	+173,991
Outlays	+5,958	+13,113	+15,638	+16,319	+16,841	+67,869	+158,283

The Individuals with Disabilities Education Act (IDEA) authorizes the federal government to make grants to states to provide special education and related services to students with disabilities. In exchange for receiving that federal funding, states are required to provide a "free appropriate public education" that is designed to meet the needs of eligible students. All of the states participate in the program. For the 2006–2007 school year, an estimated 6.8 million children will receive IDEA-covered services at an average federal cost of $1,551 per student.

For more than two decades, the authorization for this program (which was originally made through the Education for All Handicapped Children Act) has been set to provide each state with a maximum grant of 40 percent of the national average per-pupil expenditure (APPE) times an estimate of the number of disabled children that the state educates.[1] The program has never been funded at a level sufficient to meet that goal. If it had been funded at that level in 2006, states would have received a payment for each disabled child of $3,538 rather than $1,551. Although funding for the program has more than doubled since 1999, the program's appropriation for 2006 provided only about 17.5 percent of the estimated national APPE of $8,846 for that year.

This option would provide funds to meet the original federal goal of 40 percent of the APPE, which would require an increase in budget authority of $14.9 billion in 2008 and a total of $80 billion over the 2008–2012 period. The option would increase outlays by $6 billion in 2008 and by a total of $67.9 billion through 2012. Under the option, the appropriation for IDEA grants to states for 2008 would be adjusted annually to reflect estimated changes in the national APPE, in the number of children ages 3 to 21, and in the number of those children living in families whose income is below the federal poverty line.

Supporters of this option argue that the original federal goal represents a commitment to the states that should be met. In their view, public school systems are obligated to provide all children with a free appropriate education—which in the case of children with disabilities often requires costly equipment and professional attention tailored to the needs of each student. Proponents of additional federal support contend that the funds are needed to ensure that school districts can meet those obligations.

Opponents of this option believe that educating children, including disabled children, is a responsibility of state and local governments and that the federal government's involvement should be minimal. They reject the claim that the original authorization represents a federal commitment, viewing that amount instead as a ceiling for appropriations. Moreover, critics argue that certain problems with how the current system operates—such as paperwork burdens imposed on school systems and incorrect identification of disabilities (such as learning disabilities) that are more difficult to diagnose—will not be solved simply by increasing federal funding.

1. The Individuals with Disabilities Education Improvement Act of 2004 stipulates how that estimate should be developed: It is the number of disabled children in a state who were served during the 2004–2005 school year, adjusted by an average of the percentage increases since that school year in the number of the state's children ages 3 to 21 and the number ages 3 to 21 who are living in poverty.

500-4—Discretionary

Increase Funding for the Education of Disadvantaged Children

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	+12,045	+12,258	+12,483	+12,707	+12,932	+62,426	+130,680
Outlays	+5,560	+10,755	+12,138	+12,560	+12,784	+53,797	+121,092

Title I-A of the Elementary and Secondary Education Act of 1965 authorized grants to local school districts to fund supplementary educational services for children who are disadvantaged and achieving at low levels. The Improving America's Schools Act of 1994 added accountability measures to the Title I-A program that were significantly strengthened by the No Child Left Behind Act of 2001, or NCLBA. (Those measures establish annual goals for educational improvement and impose escalating sanctions when the goals repeatedly are not met.) The NCLBA authorized Title I-A grants that began at a total of $13.5 billion for 2002 and increased steadily to $25 billion for 2007. However, those grants have been funded below those authorized levels. (For example, the funding level requested for 2007 was $12.7 billion.)

This option would boost funding for Title I-A for 2008 and beyond to its authorized level for 2007—$25 billion, with subsequent adjustments for inflation—and thereby increase federal outlays by $5.6 billion in 2008 and by $53.8 billion through 2012.

The accountability measures in the NCLBA require that schools that start the farthest from the ultimate goal—that all children be proficient in reading and math by the 2013–2014 school year—make the greatest annual progress if they are to avoid sanctions. Included among those schools that have started the farthest behind are those with large concentrations of disadvantaged children. Thus, a rationale for the increase in funding under this option is that if disadvantaged children are to catch up to their more advantaged peers, unprecedented improvements in educational performance will be required. To close the gap, schools with high concentrations of disadvantaged children will probably have to dramatically increase both the quality and intensity of the supplemental educational services they provide. Those improvements will require very large increases in resources.

An argument against the funding increase is that experience with earlier reform plans shows that simply providing more resources may not solve the problem of closing the achievement gap between economically disadvantaged children and their better-off peers. Studies of what determines academic achievement among students often fail to find that the level of resources available to a school influences how well students learn. Academic achievement may be associated with qualities—such as school leadership and excellent teaching—that cannot be improved by additional resources alone.

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments,* June 1998

500-5—Discretionary

Eliminate the Even Start Program and Redirect Some Funds to Other Education Programs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-50	-51	-52	-53	-54	-261	-547
Outlays	-1	-39	-49	-52	-53	-195	-474

The Even Start family literacy program provides educational and related services to parents who have not finished high school and to their young children. Those services include basic academic instruction and help with parenting skills for the parents and early childhood education for their children, along with supplementary services such as child care and transportation. Under the program, the Department of Education makes grants to states to provide assistance through eligible entities (a local education agency operating in collaboration with a community-based or other nonprofit organization). During the 2006–2007 school year, the program supported 647 projects that served roughly 25,000 children and provided approximately $3,900 per child. The most recent national evaluation of the program found that roughly one-third of funding supported adult and parenting education and associated support services and another one-third supported early childhood education. The remainder paid for case management, recruiting, evaluation, administration, and other activities. For 2006, federal funding for the program was $99 million, down from $225 million in 2005

This option, like the President's 2008 budget, would eliminate grants to states under the Even Start program and redirect half of those funds to other federal programs that support early childhood education. That change would reduce outlays by $1 million in 2008 and by a total of $195 million over five years.

An argument for this option is that the most recent national evaluation of Even Start did not produce evidence that the program's approach of involving parents in the education of their children is effective. That evaluation included a study that tracked 18 local grantees that randomly assigned 20 new families to an Even Start program that provided the full range of services and 10 families to a control group. (Those 10 families were not allowed to participate in the Even Start program for one year but were free to seek other educational and social programs for which they qualified.) Although both groups made gains on literacy and many other measures, the parents and children in the Even Start program did not perform better than the parents and children in the control group. The national evaluation also found that maintaining families' participation in the program and use of its full range of services—which are at the core of the program's philosophy—was a continuing problem. Families in the Even Start program during the 2000–2001 school year used only a fraction of the services available to them. Also, about half of the families who joined Even Start between the 1997–1998 school year and the 2000–2001 school year left the program within 10 months, and by that time, fewer than one in five families had met their educational goals under the program.

An argument against this option is that other studies have shown that children who participate in programs that provide intensive high-quality services make larger cognitive gains while in the program and have better educational outcomes years after leaving the program than those who do not. In addition, research has repeatedly shown an association between family background, including level of education and income, and the educational achievement of children. So although direct evidence is not available, it seems plausible that children whose parents have low levels of literacy or education are more likely to be educationally successful if they receive early childhood instruction themselves and if their parents receive educational services and instruction to help their children learn. Also, those parents may be more motivated to participate in basic education programs for adults and improve their job prospects if one of the purposes of such programs is to support their children's educational development.

RELATED CBO PUBLICATION: *The Economic Effects of Federal Spending on Infrastructure and Other Investments,* June 1998

500-6—Discretionary

Increase the Maximum Pell Grant

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Increase the Maximum Grant by $100							
Change in budget authority	+415	+416	+418	+420	+432	+2,100	+4,307
Change in outlays	+99	+407	+416	+419	+423	+1,764	+3,957
Increase the Maximum Grant by $1,000							
Change in budget authority	+4,214	+4,263	+4,291	+4,316	+4,444	+21,528	+44,271
Change in outlays	+1,011	+4,141	+4,269	+4,297	+4,346	+18,064	+40,664

The Pell Grant program is the single largest source of federal grant aid for postsecondary education that is available to students from low-income families. A student's eligibility for a grant and the grant's size depend on a federal calculation of the student's and family's expected contribution to the cost of attending a postsecondary institution. The calculation depends on factors that include the student's income and assets and, for dependent students (in general, unmarried undergraduate students under the age of 24), the parent's income and assets and the number of other dependent children in the family who are attending postsecondary schools.

The amount of the grant that a student is eligible for depends on the relationship of the family's expected contribution to the maximum grant. If the expected contribution is zero, the student generally qualifies for the maximum grant; if the contribution is, for example, one-third of the maximum, the student generally qualifies for a grant equal to two-thirds of the maximum; and if the expected family contribution exceeds the maximum grant, the student is not eligible for Pell grant aid. For academic year 2006–2007, the maximum grant authorized for the program is $5,800. However, lawmakers specified a lower maximum amount—$4,050—in the program's appropriation for 2006, which provides funding for the 2006–2007 academic year.

This option would increase the appropriated maximum Pell grant by either $100 or $1,000, affecting both the size and number of grants awarded. (Most students who received a grant under current law would receive a larger one under the option, and some students who currently are not eligible for a grant would become eligible.) An increase of $100 in the appropriated maximum grant would raise federal outlays by $99 million in 2008 and by $1.8 billion over the 2008–2012 period. An increase of $1,000 would raise federal outlays by $1 billion in 2008 and by $18.1 billion during the five-year period.

An argument for increasing the maximum Pell grant by $100 or $1,000 is that the maximum award now covers only about one-third of average expenditures for in-state tuition, fees, room, and board at public four-year postsecondary institutions. Currently, fewer than 50 percent of students from low-income families enroll in college or trade school immediately after graduating from high school, compared with about 80 percent of students from upper-income families. Increasing the grant aid offered to students from low-income families might induce more of them to enroll in postsecondary education. It might also encourage some to remain in school longer.

An argument for not increasing the maximum Pell grant is that doing so would require a large increase in federal spending. Moreover, most of the additional aid that this option would provide would go to students who would attend a college or a trade school without being offered a larger grant. Other forms of aid, including federally subsidized student loans, are available to students from low-income families to help finance that part of the cost of attendance not met by Pell grants. And it could be argued that for students to bear the cost of repaying loans for their education is appropriate because they also receive significant benefits from that education.

RELATED OPTIONS: 500-7 and 500-12

RELATED CBO PUBLICATIONS: *Private and Public Contributions to Financing College Education*, January 2004; and *The Economic Effects of Federal Spending on Infrastructure and Other Investments,* June 1998

500-7—Discretionary

Verify the Income Amount That Pell Grant Awardees Report on Their Student Aid Applications

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-50	-120	-190	-220	-240	-820	-2,090
Outlays	-12	-64	-133	-196	-221	-625	-1,879

Individuals who apply for federal student financial aid must complete the Free Application for Federal Student Aid, on which they report their income and, if they are dependent students, the income of their parents. Those amounts are among the key factors that determine the size of a federal Pell grant or subsidized loan—if any—that a student is eligible to receive. The Department of Education generally requires that postsecondary institutions verify a student's reported income and family size on at least 30 percent of the applications for federal aid that the schools receive; institutions do that by asking students to produce such documents as copies of income tax returns. Through that verification process, the department has found that a significant fraction of applicants understate their income, which can lead to awards of Pell grants and subsidized loans that are larger than those for which a student is eligible. (A smaller number of students overstate their income and are awarded less aid than the amount for which they are eligible.)

This option would direct the Internal Revenue Service to share information about income with the Department of Education and its contractors so that they can verify the amounts that all Pell grant awardees have reported on their aid applications. The option would also allow the department to disclose any discrepancies to postsecondary institutions—which administer the Pell Grant program—so that they can adjust the amounts of students' awards. If the current maximum award of $4,050 continued to apply over the next 10 years, reducing Pell grant overpayments would shrink federal outlays by $12 million in 2008 and by $625 million over the 2008–2012 period. Those estimates incorporate the assumption that the Department of Education will first focus on large Pell grant awards and gradually extend the verification program to all awards. A small reduction in outlays under this option would also come from decreasing the amounts of federally subsidized loans received by Pell grant awardees who underreport their income.

An argument for this option is that the verification of Pell grant awardees' income would ensure that such recipients of federal student aid received only the amount they were eligible for under the government's student aid formulas and that applicants who had the same income and family circumstances were treated similarly. Income verification might also give students and families an incentive to provide more accurate information on the aid application. Another benefit of implementing the option would be to centralize the location of sensitive information about family income. The Department of Education's current verification system requires that students present copies of tax returns to their postsecondary institutions, which means such information can be found in financial aid offices all over the country.

An argument against this option is that the income verification process could disrupt some students' educational plans. If colleges were required to delay financial aid awards until after the information on aid applications was verified through filed tax returns, students whose parents did not file their returns well before the start of an academic year might see the disbursement of their grant award postponed, which in turn might delay their enrollment. Another argument against this option is that some people might perceive income verification by the Internal Revenue Service as an infringement on taxpayers' privacy.

RELATED OPTIONS: 500-6 and 500-12

RELATED CBO PUBLICATION: *Private and Public Contributions to Financing College Education,* January 2004

500-8—Mandatory

Standardize the Interest Rates Charged on PLUS Loans

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Standardize rates at 7.9 percent	+140	+155	+170	+185	+200	+850	+2,115
Standardize rates at 8.5 percent	-30	-30	-35	-40	-40	-175	-430

Federal student loan programs give students and their parents the opportunity to borrow funds to pay for postsecondary education. Those programs offer Stafford loans to students and PLUS loans to parents of dependent students and (more recently) to graduate students who have exhausted their eligibility for Stafford loans. (PLUS loans take their name from the original Parent Loans to Undergraduate Students program.) Two programs provide both Stafford and PLUS loans: the Federal Family Education Loan Program, in which the federal government guarantees loans made by private lenders; and the William D. Ford Federal Direct Loan Program, in which the government makes the loans by using federal funds. The interest rate on Stafford loans is the same under both programs—6.8 percent on loans made after July 1, 2006. However, the interest rate on PLUS loans made after July 1, 2006, differs: it is 8.5 percent under the guaranteed loan program and 7.9 percent under the direct loan program.

This option would standardize the interest rate on PLUS loans offered under the two programs by either reducing the rate on guaranteed loans (to 7.9 percent) or raising it on direct loans (to 8.5 percent). Reducing the rate on guaranteed student loans would increase federal outlays by $140 million in 2008 and by $850 million over the 2008–2012 period. (Outlays would rise because the government guarantees lenders an interest rate and pays them the difference between that rate and the rate that borrowers pay.) Raising the interest rate on direct loans would reduce federal outlays by $30 million in 2008 and by $175 million over the 2008–2012 period. (Outlays would decline because the government would receive larger interest payments from borrowers in the direct loan program.)

An argument for the alternative of reducing the interest rate is that the lower rate (7.9 percent) is already well above the interest rate on Stafford loans (6.8 percent). However, an argument against the alternative is that it would increase federal outlays.

A rationale for the alternative of raising the interest rate is that PLUS loans are available to parents and graduate students regardless of their income and assets and, for many borrowers, an 8.5 percent rate may be less than the interest rate on alternative private loans available to them. However, by raising the interest rate, policymakers would increase the cost of financing postsecondary education for parents and graduate students who already face high levels of expenditures.

RELATED OPTION: 500-10

RELATED CBO PUBLICATIONS: *The Cost of the Consolidation Option for Student Loans,* May 2006; and *Subsidy Estimates for Guaranteed and Direct Student Loans,* November 2005

500-9—Mandatory

Eliminate Subsidized Loans to Graduate Students

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2012
Change in Spending							
Budget authority	-1,825	-1,925	-2,010	-2,075	-2,130	-9,965	-21,320
Outlays	-1,085	-1,670	-1,750	-1,810	-1,860	-8,175	-18,110

Federal student loan programs allow students and their parents to borrow funds to pay for students' postsecondary education. Those programs offer subsidized loans to students who have proven financial need and unsubsidized loans to students regardless of need. Two programs provide both types of loans: the Federal Family Education Loan Program, in which the federal government guarantees loans made by private lenders; and the William D. Ford Federal Direct Loan Program, in which the government makes loans by using federal funds. Borrowers benefit because the interest rates that they are charged are lower than the rates that most of them could secure from alternative sources. Borrowers who receive subsidized loans benefit further because the federal government forgives interest on those loans while students are in school and during a six-month grace period after they leave school.

This option would end new subsidized loans to graduate students in 2007. Under the assumption that those students would then take out unsubsidized loans instead, this option would reduce federal outlays by $1.1 billion in 2008 and by $8.2 billion over the 2008–2012 period. (Under the Federal Credit Reform Act of 1990, the federal budget records all costs and collections associated with a new loan on a present-value basis in the year in which the loan is obligated.)

An argument for restricting subsidized loans to undergraduate students is that it would focus student aid funding on what some people believe is the federal government's primary role in higher education—to make a college education available to all high school graduates. According to that rationale, graduate students have already benefited from higher education. An argument against such a shift in funding, however, is that supporting graduate students is an equally important role of the federal government because those students are most likely to make scientific, technological, and other advances that will benefit society as a whole.

Under this option, graduate students who lost access to subsidized loans could take out unsubsidized federal loans for the same amount and still benefit from below-market interest rates. Nevertheless, graduate students often amass large student loan debts because of the number of years of schooling required for their degrees. Without the benefit of interest forgiveness while they were enrolled in school, their debt would be substantially larger when they entered the repayment period because the interest on the amounts they had borrowed over the years would be added to their loan balance. However, the federal student loan programs have several options for making repayment manageable for students who have high loan balances or difficult financial circumstances.

RELATED CBO PUBLICATION: *Private and Public Contributions to Financing College Education,* January 2004

500-10—Mandatory

Reduce Lenders' Yields on PLUS Loans

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-90	-100	-105	-120	-130	-545	-1,345
Outlays	-70	-80	-85	-90	-100	-425	-1,060

Under the Federal Family Education Loan Program, private lenders make loans to students and their parents that are guaranteed by the federal government. The program provides two types of loans to borrowers: Stafford loans and PLUS loans. (PLUS originally referred to the Parent Loans to Undergraduate Students program, but the loans are now available to graduate students as well as parents.) Stafford loans are better for borrowers because their terms are more favorable than those of PLUS loans. However, students cannot always finance enough of the cost of attending school with the maximum Stafford loan available to them, so some parents and graduate students may take a PLUS loan to finance the remainder. PLUS loans have an advantage for lenders: The government guarantees an interest rate on those loans that is 0.3 percentage points higher than the rate on Stafford loans. For the fourth quarter of 2006, for example, the rate that lenders received on recent Stafford loans was 7.72 percent. By comparison, the rate they received on PLUS loans was 8.02 percent.

This option would reduce the guaranteed interest rate that lenders receive on PLUS loans to equal the guaranteed rate they receive on Stafford loans. Because the federal government pays lenders the difference between the guaranteed interest rate and the borrower's interest rate, that change would reduce federal outlays by $70 million in 2008 and by $425 million over the years 2008 to 2012.

Whether lenders should receive a higher interest rate on PLUS loans than on Stafford loans hinges, in part, on whether they incur higher costs or risks for PLUS loans. On the one hand, the loan-servicing requirements that the government imposes are the same for both kinds of loan, and the government guarantees both. Furthermore, PLUS loans, on average, are much larger than Stafford loans, which may allow lenders to service the loans more efficiently. On the other hand, under the government's requirements for PLUS loans, lenders must check the borrower's credit history, a step that is not required for Stafford loans and that imposes a small additional cost on lenders.

RELATED OPTION: 500-8

RELATED CBO PUBLICATION: *How CBO Analyzes the Sources of Lenders' Interest Income on Guaranteed Student Loans,* June 2004

500-11—Mandatory

Reduce Fees for Collection-Related Services Paid to Guaranty Agencies Under the Federal Family Education Loan Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-155	-160	-170	-180	-185	-850	-1,885
Outlays	-130	-140	-145	-155	-160	-730	-1,635

Under the Federal Family Education Loan Program, private lenders make loans to students, and those loans carry a federal guarantee that is administered by several dozen guaranty agencies. When a borrower defaults on a student loan, a guaranty agency pays the lender what it is owed and is then responsible for collecting the unpaid amount (plus any collection fee) from the borrower. If the guaranty agency is successful and the borrower begins to make payments or repays the loan in full, the agency may retain a portion of those payments.

Under the William D. Ford Direct Education Loan Program, the government lends money to students directly by using federal funds. Contractors, selected by the Department of Education through a competitive process, provide collection services for the program that are analogous to those provided by guaranty agencies. Like those agencies, the contractors are permitted to retain a portion of the payments they collect; however, that portion is smaller than the one that a guaranty agency may retain.

The amount that a guaranty agency or contractor may retain depends on how a loan payment is obtained. For payments received directly from borrowers, a guaranty agency may retain 23 percent, but the Department of Education's contractors retain an average of about 16 percent.

This option would reduce the amount that a guaranty agency may retain from payments on defaulted loans, lowering it to the amount that the Department of Education allows its contractors to retain. The option would reduce federal outlays for new loans made during the 2008–2012 period by $130 million in 2008 and by $730 million through 2012. The option would reduce federal outlays for loans made in earlier years by an additional $635 million. (Under the Federal Credit Reform Act of 1990, the federal budget records all costs and collections associated with a new loan on a present-value basis in the year in which the loan is obligated. The federal budget records modifications associated with an existing loan in the year in which the modifications are enacted.)

The primary argument for this option is that the guaranty agencies and the Department of Education's collection contractors provide analogous services and should be similarly compensated for them. A rationale for using the amount that contractors are paid is that it is determined through a competitive process in which the collection companies either accept prices and fees offered by the department or propose changes. In the latter case, the agency evaluates the prices to ensure that the rates are high enough to provide the contractor with an incentive to maximize its collections on the defaulted loans and low enough to give the government a reasonable return on the loans.

An argument against this option is that guaranty agencies are state-sponsored or nonprofit organizations whose mission is to help students finance their education. Any payments they receive that exceed their costs are not distributed as profits to owners (as is generally the case for the collection contractors) but are kept in the organizations' operating fund for future uses—which may include providing additional aid to students.

500-12—Discretionary

Eliminate Administrative Fees Paid to Schools in the Campus-Based Student Aid and Pell Grant Programs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-186	-190	-193	-197	-200	-966	-2,023
Outlays	-22	-182	-190	-194	-197	-785	-1,824

In several federal student aid programs, the government pays schools to administer the programs or distribute the funds, or both. One type of program, campus-based aid, includes the Federal Supplemental Educational Opportunity Grant Program, the Federal Perkins Loan Program, and the Federal Work-Study Program. The government distributes funds for those programs to institutions, which in turn award grants, loans, and jobs to qualified students. Under a statutory formula, institutions are allowed to use up to 5 percent of those program funds for administrative costs. In another program, the Federal Pell Grant Program, the law provides for a federal payment of $5 per Pell grant to reimburse schools for some of their costs of administering that program.

This option would prohibit schools from using federal funds from the campus-based aid programs to pay administrative costs, which would reduce budget authority by $160 million in 2008. Eliminating the $5 payment per grant to schools in the Pell Grant program would reduce budget authority by another $26 million. Together, those changes would reduce outlays by a total of $785 million over the 2008–2012 period.

Arguments can be made both for eliminating those administrative payments and for retaining them. On the one hand, schools benefit significantly from participating in federal student aid programs even without the payments because the aid makes attendance at those schools more affordable. For the 2006-2007 academic year, students at participating institutions will receive an estimated $15 billion in federal funds under the Pell Grant and campus-based aid programs. On the other hand, institutions incur costs to administer the programs. If the federal government does not pay those expenses, schools may simply pass along the costs to students in the form of higher tuition or less institutional student aid.

RELATED OPTIONS: 500-6 and 500-7

500-13—Discretionary

Eliminate the Leveraging Educational Assistance Partnership Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-66	-67	-69	-70	-71	-343	-717
Outlays	-13	-66	-68	-69	-70	-286	-655

The Leveraging Educational Assistance Partnership (LEAP) program helps states provide grants and work-study assistance to financially needy postsecondary students while they attend academic institutions or vocational schools. States must match federal funds at least dollar for dollar and must also meet maintenance-of-effort criteria (minimum funding levels based on funding in previous years). Unless they are excluded by state law, all public and private nonprofit postsecondary institutions in a state are eligible to participate in the LEAP program.

This option, which was also included in the President's 2008 budget, would eliminate the LEAP program, reducing federal outlays by $13 million in 2008 and by $286 million over five years. The extent to which financial assistance to students declined would depend on the responses of the states, some of which would probably make up at least part of the lost federal funds.

A rationale for this option is that the LEAP program is no longer needed to encourage states to provide more student aid. When the program was first authorized, in 1972 (as the State Student Incentive Grant Program), only 28 states had student grant programs; now, all but one state have such need-based assistance. Moreover, states currently fund the LEAP program far in excess of the level to which federal matching funds apply.

An argument against eliminating the LEAP program is that some states might not increase their student aid appropriations to make up for the lost federal funds and some might even reduce them. In that case, some of the students who received less aid might not be able to enroll in college or might have to attend a less expensive school.

RELATED CBO PUBLICATION: *Private and Public Contributions to Financing College Education,* January 2004

500-14—Discretionary

Reduce Funding for the Arts and Humanities

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-329	-366	-405	-445	-482	-2,028	-5,097
Outlays	-275	-335	-391	-436	-474	-1,912	-4,933

The federal government subsidizes various activities related to the arts and humanities. For 2007, combined funding for several programs totals nearly $1.5 billion; it comprises federal spending for the Smithsonian Institution ($632 million), the Corporation for Public Broadcasting ($465 million), the National Endowment for the Humanities ($141 million), the National Endowment for the Arts ($124 million), the National Gallery of Art ($111 million), and the John F. Kennedy Center for the Performing Arts ($31 million).

Cutting funding for those programs by 20 percent of their current outlays and holding spending at that nominal level would reduce federal outlays relative to the current funding level (after an adjustment for inflation) by $275 million in 2008 and by $1.9 billion over the 2008–2012 period. The actual effect on arts and humanities activities would depend in large part on the extent to which other funding sources—such as states, localities, individuals, firms, and foundations—changed their contributions.

Some proponents of reducing or eliminating funding for the arts and humanities argue that support of such activities is not an appropriate role for the federal government. Other advocates of cuts suggest that the expenditures are particularly unacceptable when programs that address central federal concerns are not being fully funded. Some federal grants for the arts and humanities already require nonfederal matching contributions, and many museums charge or suggest that patrons pay an entrance fee. Those practices could be expanded to accommodate a reduction in federal funding.

However, critics of cuts in funding contend that alternative sources will probably be unable to fully offset a drop in federal subsidies. Subsidized projects and organizations in rural or low-income areas might find it especially difficult to garner increased private backing or sponsorship. Thus, a decline in federal support, opponents argue, would reduce activities that preserve and advance the nation's culture and that introduce the arts and humanities to people who might not otherwise have access to them.

500-15—Discretionary

Eliminate the Senior Community Service Employment Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-440	-448	-456	-464	-473	-2,281	-4,776
Outlays	-75	-428	-445	-455	-463	-1,865	-4,310

The Senior Community Service Employment Program (SCSEP) funds part-time jobs for people ages 55 and older who have low income and poor prospects for employment. To participate in the program in 2006, a person had to have annual income of less than 125 percent of the federal poverty level. (For someone living alone, that amount would be $12,250.) SCSEP grants are awarded to nonprofit organizations and state agencies. Those organizations and agencies pay SCSEP participants to work in part-time community service jobs.

This option would eliminate the SCSEP, reducing outlays by $75 million in 2008 and by $1.9 billion through 2012.

Participants in the SCSEP are paid the federal or state minimum wage or the local prevailing wage for similar employment, whichever is higher. They are also offered annual physical examinations, training, counseling, and assistance to move into unsubsidized jobs when they complete their projects. In 2006, approximately 100,000 people participated in the SCSEP, working in schools, hospitals, and senior citizens' centers and on beautification and conservation projects.

An argument for eliminating the SCSEP is that the costs of providing the services now supplied by the program's participants could be borne by the organizations that benefit from their work; under current law, those organizations usually must bear just 10 percent of such costs. Shifting the full costs of the services to the organizations would increase the likelihood that only the most highly valued services would be provided.

An argument against this option is that eliminating the SCSEP, which is a major federal jobs program aimed at low-income older workers, could cause serious financial problems for some people. In general, older workers are less likely than younger workers to be unemployed, but those who are unemployed take longer to find work.

500-16—Discretionary

Eliminate Funding for the National and Community Service Act

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-527	-538	-549	-560	-572	-2,746	-5,793
Outlays	-70	-248	-367	-448	-484	-1,616	-4,419

The National and Community Service Act authorizes funds for the AmeriCorps Grants Program, the National Civilian Community Corps (NCCC), Learn and Serve America, and the Points of Light Foundation; AmeriCorps receives the bulk of the total appropriations. Students and other volunteers who participate in those programs provide assistance to their communities in the areas of education, public safety, the environment, and health care, among others. State and local governments and private enterprises contribute additional funds to AmeriCorps to carry out service projects that, in many cases, build on existing federal, state, and local programs. AmeriCorps and NCCC provide participants with an educational allowance, a stipend for living expenses, and, if needed, health insurance and child care. Participants in the Learn and Serve America program generally do not receive stipends or educational awards. The Points of Light Foundation is a nonprofit organization that promotes volunteer activities.

This option would eliminate federal contributions for programs funded under the National and Community Service Act, reducing outlays relative to current funding by $70 million in 2008 and by $1.6 billion through 2012 after an adjustment for inflation. (Those estimates include the costs associated with terminating the programs.)

An argument for the option is based on the view that the main goal of federal aid to students should be to provide access to postsecondary education for people whose income is low. Because participation in the programs is not based on family income or assets, funds do not necessarily go to the poorest students.

A major rationale for maintaining the programs is that they provide opportunities for participants to engage in national service, which can promote a sense of idealism among young people. In addition, participants provide valuable services to their communities.

550

Health

Health care services account for almost 90 percent of spending in function 550. Health-related research and training programs consume a little over 10 percent, and about 1 percent of spending goes to consumer and occupational health and safety. On average, spending for health care services and health research and training has grown by 7 percent annually since 2002; spending for consumer and occupational health and safety programs has grown by about 5 percent per year over the same period.

The largest component of mandatory spending for health care services in function 550 is Medicaid, which funds health services for low-income women, children, and elderly people and for people with disabilities. (Medicare, in budget function 570, is the largest federal health care program.) The federal government shares the cost of Medicaid with the states, and, since 2002, federal Medicaid spending has grown at an average annual rate that is slightly above 5 percent. The Congressional Budget Office projects that federal Medicaid spending will total $192 billion in 2007 and will grow by roughly 8 percent per year from 2007 through 2017.

Other mandatory programs in function 550 pay for health care services for children in some low-income families and for federal civilian or military retirees. Most of the discretionary spending for health care is disbursed by the Centers for Disease Control and Prevention, the Health Resources and Services Administration (HRSA), the Indian Health Service, and the Substance Abuse and Mental Health Services Administration.

Spending for health research and training mainly funds programs of the National Institutes of Health (NIH) and HRSA that provide grants or loans to health professionals. NIH funding grew by a total of 22 percent from 2002 to 2006.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

	2002	2003	2004	2005	2006	Estimate 2007[a]	Average Annual Rate of Growth (Percent) 2002-2006	2006-2007
Discretionary Budget Authority	45.8	49.4	50.8	52.0	56.5	52.1	5.4	-7.8
Outlays								
Discretionary	39.4	44.2	47.7	50.5	51.4	52.7	6.9	2.5
Mandatory	157.1	175.3	192.4	200.1	201.4	215.5	6.4	7.0
Total	196.5	219.6	240.1	250.6	252.8	268.1	6.5	6.1

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 15 *Reduce the Tax Exclusion for Employer-Paid Health Insurance*

Revenue Option 63 *Finance the Food Safety and Inspection Service Solely Through Fees*

Revenue Option 64 *Establish New Fees for the Food and Drug Administration*

550-1—Mandatory

Equalize Federal Matching Rates for Administrative Functions in Medicaid

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,160	-1,420	-1,810	-1,930	-2,060	-8,380	-20,860

The federal government pays a portion of the costs that states incur to administer their Medicaid programs. The basic federal matching rate is 50 percent for most administrative activities. In some cases, however, the federal subsidy is higher. For example, the federal government pays 75 percent of the cost of employing skilled medical professionals for Medicaid administration, 75 percent of the cost of utilization review (the process of determining the appropriateness and medical necessity of various health care services), 90 percent of the cost of developing systems to manage claims and information, and 75 percent of the cost of operating such systems.

This option would set the federal matching rate for all Medicaid administrative costs at 50 percent. That change would save $1.2 billion in 2008 and $8.4 billion over five years. The President has included this proposal in his 2008 budget.

Enhanced matching rates were designed to encourage states to develop and support particular administrative activities that the federal government considers important for the Medicaid program. Once those administrative systems are operational, however, there may be less reason to continue the higher subsidy. Moreover, because states pay, on average, about 43 percent of the cost of health care for Medicaid beneficiaries, they have a substantial incentive to maintain efficient information systems and employ skilled professionals.

A potential drawback of this option is that a reduced federal subsidy might cause states to cut back on some beneficial activities, with adverse consequences for program management. For example, states might hire fewer nurses to conduct utilization reviews and oversee care in nursing homes, or they might make fewer improvements to their information-management systems.

RELATED OPTIONS: 550-2 and 550-3

550-2—Mandatory

Restrict the Allocation of Common Administrative Costs to Medicaid

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-280	-320	-390	-390	-390	-1,770	-3,720

The federal government's three major public assistance programs—Temporary Assistance for Needy Families (TANF), Food Stamps, and Medicaid—have certain administrative tasks in common. For instance, during the enrollment process, each program requires that potential recipients provide information about their family's income, assets, and demographic characteristics. Before the 1996 welfare reform law, which replaced Aid to Families with Dependent Children (AFDC) and some related programs with the TANF block-grant program, all three programs reimbursed states for 50 percent of most administrative costs. As a matter of convenience, states usually charged the full amount of those common administrative costs to AFDC.

The TANF block grants are calculated on the basis of past federal welfare spending, including what the states received as reimbursement for administrative costs. Because states had previously paid the common administrative costs of their AFDC, Medicaid, and Food Stamp programs from AFDC funds, those amounts are now included in their TANF block grants. However, the Department of Health and Human Services now requires each state to charge Medicaid's share of common administrative costs to the federal Medicaid program, even if that amount is already implicitly included in the state's TANF block grant. As a result, many states are in effect being paid twice for at least a portion of Medicaid's share of common administrative costs.

For any state that receives such a double payment, this option would limit the federal reimbursement for administrative costs for Medicaid to the amount not included in the state's TANF block grant. Federal outlays would decline by $280 million in 2008 and by almost $1.8 billion through 2012. Overall, the reduction in Medicaid funding would equal about one-third of the common costs of administering the Medicaid, AFDC, and Food Stamp programs that were charged to AFDC in 1996—the base period used to determine the amount of the TANF block grant. (A similar adjustment has already been made in the amount that the federal government pays the states to administer the Food Stamp program.) The President's 2008 budget includes this proposal.

A rationale for this option is that it would eliminate the current implicit double payment to states. A potential drawback is that reducing federal reimbursement could hamper states' efforts to enroll additional eligible children in Medicaid and the State Children's Health Insurance Program. Such action could also prompt states to restrict eligibility or services for those two programs.

RELATED OPTIONS: 550-1 and 550-3

550-3—Mandatory

Reduce Spending for Medicaid's Administrative Costs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-460	-650	-830	-960	-1,140	-4,040	-13,040

The federal government reimburses states for about 50 percent of the cost of managing their Medicaid programs. Under this option, the federal government would reduce its spending for Medicaid's administrative costs by capping the per-enrollee amount that it pays each state for Medicaid administration. The cap would grow by 5 percent annually—a rate slower than that at which administrative costs have grown in the past—from a base-year amount that represents the per-enrollee administrative costs for which each state claimed matching payments in 2006.

A rationale for this option is that such a change would result in savings totaling $460 million in 2008 and $4.0 billion through 2012. (Limiting federal payments for administrative costs to a 5 percent growth rate would produce savings because the actual growth rate of those costs is projected to be about 9 percent in 2007, about 8 percent in 2008 and 2009, and then about 7 percent in ensuing years.) Another rationale for implementing the option is that it would give states a stronger incentive to improve the efficiency with which they manage their Medicaid programs.

An argument against this option is that, faced with fewer administrative resources, states might cut back on some activities that could improve the functioning of their Medicaid programs. For example, they might reduce funding for efforts to combat waste, fraud, and abuse.

RELATED OPTIONS: 550-1 and 550-2

550-4—Mandatory

Increase the Flat Rebate Paid by Drug Manufacturers for Medicaid Prescription Drugs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-130	-260	-290	-320	-350	-1,350	-3,610

Spending by the Medicaid program for prescription drugs increased at an average real (inflation-adjusted) rate of 13 percent annually between 2000 and 2005, with the federal component of that spending reaching $17.9 billion in 2005. With the introduction in January 2006 of the Medicare drug benefit, Medicaid spending for prescription drugs fell substantially, to $10.2 billion, largely because coverage for so-called dual eligibles—people who are covered under both Medicare and Medicaid—is now provided by Medicare. The lower level of spending for Medicaid, however, is still subject to upward pressures similar to those affecting overall prescription drug spending.

The amount that Medicaid pays for a particular drug depends on two prices: the average wholesale price (AWP), a list price published by the manufacturer; and the average manufacturer's price (AMP), which is the average price that the manufacturer actually receives for drugs distributed to retail pharmacies and mail-order establishments. For brand-name drugs, state Medicaid agencies typically pay the AWP minus a percentage (ranging from 10 percent to 15 percent, depending on the state) plus a dispensing fee. A portion of that spending is recouped by both the federal and state governments through a rebate paid by the manufacturer to Medicaid.

For brand-name drugs, the basic rebate is equal to the maximum of a fixed, or flat, percentage of the AMP—15.1 percent currently—and the difference between the AMP and the "best price" at which the manufacturer sells the drug to any private purchaser. An additional rebate applies if the AMP grows faster than inflation. (Makers of generic drugs must rebate 11 percent of the AMP to the state Medicaid agency.) Overall, Medicaid receives an average rebate from manufacturers of slightly more than 20 percent under the current pricing system (not including the additional rebate tied to price inflation).

This option would boost the flat rebate from 15.1 percent to 20 percent. That change would increase the average Medicaid rebate (relative to the AMP) to about 24 percent, reducing mandatory federal spending by $130 million in 2008 and by $1.4 billion through 2012.

Although many manufacturers offer large discounts to private purchasers, the best-price provision discourages them from offering discounts beyond the flat rebate because any such discount automatically triggers a greater Medicaid rebate. A higher flat rebate percentage, however, would allow manufacturers to offer slightly greater discounts without triggering the best-price provision. Thus, beyond reducing Medicaid spending for prescription drugs, this option might in certain cases enable some private purchasers to buy certain drugs at lower prices. The interaction of the higher basic rebate with the additional inflation-adjusted rebate, however, makes the ultimate effect of this option on prices paid by private purchasers difficult to predict.

A potential drawback of this option is that pharmaceutical firms, faced with reduced revenues from Medicaid, might invest less money in research and development in certain drug classes whose use is heavily concentrated in the Medicaid population.

RELATED CBO PUBLICATIONS: *Medicaid's Reimbursement to Pharmacies for Prescription Drugs*, December 2004; and *How the Medicaid Rebate on Prescription Drugs Affects Pricing in the Pharmaceutical Industry,* January 1996

550-5—Mandatory

Convert Medicaid's Payments for Acute Care Services into a Block Grant

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Index Grant to Change in Input Prices							
Change in budget authority	-6,860	-11,980	-17,010	-22,670	-28,710	-87,230	-347,950
Change in outlays	-6,990	-11,700	-16,270	-21,400	-26,880	-83,240	-323,810
Index Grant to Change in Input Prices and Population							
Change in budget authority	-5,000	-9,080	-12,960	-17,370	-22,060	-66,470	-269,710
Change in outlays	-5,590	-9,270	-12,820	-16,850	-21,130	-65,660	-256,020

The Medicaid program funds coverage for two broadly different types of health care: acute care (including services such as inpatient hospital stays and visits to physicians' offices, and products such as prescription drugs); and long-term care (services such as nursing home care and home- and community-based assistance). The program is financed jointly by the states and the federal government, with the federal government's share determined as a percentage of overall Medicaid spending. That percentage, referred to as the federal matching rate, can range from 50 percent to 83 percent, depending on a state's per capita income. (The matching rate averages 57 percent nationwide.) Although the federal match helps states provide health coverage to disadvantaged populations, it may also encourage higher spending by subsidizing each additional dollar spent on Medicaid by states. The federal share of Medicaid's outlays in 2007 is estimated to be $113 billion for acute care and $59 billion for long-term care.

This option would convert the federal share of Medicaid's payments for acute care services into a block grant, as 1996 legislation did with funding for welfare programs. (Long-term care would continue to be financed as under current law.) Each state's block grant would equal its 2006 federal Medicaid payment for acute care, indexed to the increase in input prices faced by providers of medical care. (An "input" is a factor used in the production of medical care, such as professional labor, office space, and so on.) That change in financing would reduce federal outlays by $7.0 billion in 2008 and by $83.2 billion over five years. The change generates savings because federal Medicaid payments are projected under current law to grow faster than input prices. (Alternatively, block grants could be indexed both to increases in input prices and to the change in each state's population. In that case, savings would be $5.6 billion in 2008 and would grow at a slower rate thereafter, totaling $65.7 billion over five years.) In exchange for slower growth in payments, states would be given more flexibility in how they could use the funds to meet the needs of their low-income and uninsured populations.

A rationale for this option is that a block grant rather than federal matching payments would eliminate the federal subsidy for each additional dollar spent by states on acute care. Block-grant proposals in the past have typically coupled a change in financing with increased discretion for states to design and administer their programs. For example, states, if given increased discretion, could modify their benefit packages and make corresponding adjustments in the number of people covered. In addition, block grants would eliminate states' ability to use funding strategies designed to maximize federal assistance.

An argument against this option is that converting acute care payments into a block grant would reduce the total amount of federal support for Medicaid and also shift the cost burden to the states. As a result, ending federal matching payments for acute care services could provide an incentive for states to scale back their Medicaid spending. Unless states were willing to pay more themselves or were able to find ways to provide more cost-effective care, access to health services for lower-income people might be reduced. Another argument against the option is that distinguishing between acute and long-term care for the purposes of financing could be difficult administratively. For example, in order to facilitate their recovery, former hospital patients often require services after an inpatient

stay that resemble long-term care. Finally, greater state discretion creates the potential for increased disparity across states in eligibility requirements and benefit packages.

RELATED OPTION: 550-6

550-6—Mandatory

Convert Medicaid's Disproportionate Share Hospital Payments into a Block Grant

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	+150	+10	-140	-250	-370	-600	-4,230

Hospitals that serve a disproportionately large share of low-income patients may receive higher payments from Medicaid—if the hospitals meet certain federal criteria—than other hospitals do. States have some discretion in determining not only which hospitals receive those so-called disproportionate share hospital (DSH) payments but also the size of those payments. During the late 1980s and early 1990s, many states engaged in funding transfers using the DSH program to obtain increased federal Medicaid funding without raising their net spending on DSH hospitals—effectively boosting the federal matching rate above that specified in law.

To rein in that practice, lawmakers enacted a series of restrictions on Medicaid DSH payments during the 1990s that included setting fixed ceilings on DSH payments to each state. The Medicare Modernization Act of 2003 raised those ceilings by $1.2 billion in 2004 and by smaller amounts in later years. The Congressional Budget Office projects that under current law, federal outlays for Medicaid DSH payments, which totaled an estimated $8.8 billion in 2006, will rise to $10.2 billion in 2012.

This option would convert the Medicaid DSH program into a block grant to the states. The grant could be reduced below levels under current law; or its future growth could be limited to a slower rate than that at which Medicaid DSH payments would increase under current law; or both approaches could be implemented. In exchange for less funding, states could be given greater flexibility to use the funds to meet the needs of their low-income and uninsured populations in more cost-effective ways.

As an illustration of how this option could be structured, the block grant for each state in 2008 could equal 90 percent of the state's Medicaid DSH allotment for 2007. In subsequent years, the block grant could be indexed to the increase in the consumer price index for all urban consumers minus 1 percentage point. In that case, outlay savings from this option would total $600 million through 2012. (The option would increase costs at first because states do not currently spend all of their allotted DSH money as a result of the criteria and conditions that must be met—conditions that would be removed under this option.)

A rationale for converting to a block grant is that, in addition to the budgetary savings that would eventually result under this option, the increased latitude provided to the states could result in DSH funds being better targeted to facilities and providers that serve low-income populations. For example, states would have greater flexibility to use those funds to support outpatient clinics and other nonhospital providers that treat Medicaid beneficiaries and low-income patients.

State governments, however, might not increase their contributions to make up for the reduction in federal subsidies. As a result, hospitals (and health care providers in general) could receive less in combined federal and state Medicaid subsidies and, consequently, they might not be able to serve as many low-income patients. Another potential effect is that giving states more flexibility to allocate DSH payments could alter the distribution and amount of assistance among hospitals, possibly resulting in some hospitals' receiving less public funding than they do now. Finally, states may already have enough flexibility under current rules to allocate DSH payments to achieve the maximum benefit.

RELATED OPTIONS: 550-5 and 570-8

550-7—Mandatory

Reduce the Taxes That States Are Allowed to Levy on Medicaid Providers

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-130	-660	-1,100	-1,170	-1,430	-4,490	-13,060

Medicaid is a joint federal/state program that pays for health care services for a variety of low-income individuals. The states operate the program and receive financial assistance from the federal government in the form of matching payments: The states pay for services for Medicaid beneficiaries; submit evidence of payments for medical claims to the federal government; and receive matching federal funds that may range from 50 percent to 83 percent of those states' payments, depending on the per capita income of the state. That payment mechanism can, in some instances, create an opportunity for states to inflate their payments for medical claims in order to maximize the federal assistance they receive.

Many states finance part of their share of Medicaid spending by imposing taxes on health care providers. States typically impose taxes on a particular type of provider and use the revenues to increase payment rates to those same providers. In the process, states collect federal Medicaid funds to cover a portion of those higher payments. In a simple example, a state pays a provider $100 for services provided to Medicaid beneficiaries and receives a federal matching payment of 50 percent of that amount. In the absence of a provider tax, the state and federal governments would each pay $50 for the services. But suppose the state assesses a tax on the provider of 6 percent of gross revenue—the maximum allowed in 2007—and pays the provider $106 for Medicaid services (amounts are rounded to the nearest dollar). The provider's net payment from the state for the Medicaid services is still $100 ($106 - $6). The federal government reimburses the state for 50 percent of the payment—$53 ($106 * 0.5), leaving the state paying only $47 ($53 - $6). The effective federal matching payment thus increases from 50 percent to 53 percent in that example.

The 109th Congress reduced the rate of allowable taxes levied on Medicaid providers from 6 percent to 5.5 percent for the period beginning January 1, 2008, and ending September 30, 2011 (see Public Law 109-432); this option would gradually reduce that rate further, to 3.0 percent by 2010, and make the limit permanent. This option would reduce federal spending by $130 million in 2008 and by $4.5 billion over five years.

The primary rationale for this option is that it would reduce federal Medicaid expenditures. By lowering the ceiling on allowable taxes, this option would limit the extent to which states could use such taxes to effectively inflate their federal matching rate. An argument against this option is that the lower payments to states that would result could lead to fewer people receiving Medicaid assistance, less assistance being provided per covered Medicaid beneficiary, or reduced spending by states on other activities.

550

RELATED CBO PUBLICATION: Testimony on *Medicaid Spending Growth and Options for Controlling Costs,* July 13, 2006

550-8—Mandatory

Expand Medicaid Eligibility to Low-Income Parents

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	+860	+2,290	+3,370	+4,080	+4,330	+14,930	+40,820

In low-income families, children are much more likely than adults to qualify for public health insurance. As a result of the Medicaid expansions that began in the late 1980s and enactment of the State Children's Health Insurance Program (SCHIP) in 1997, the great majority of children in families with income below 200 percent of the federal poverty level are now eligible for either Medicaid or SCHIP. For parents, however, states generally limit Medicaid eligibility to those with income substantially below the federal poverty level ($17,170 for a family of three in 2007). Several states have expanded eligibility for public coverage to parents at higher income levels.

Under this option, states would be required to expand Medicaid eligibility to all parents with income below the federal poverty level. That new requirement, which would provide coverage to 2.8 million low-income adults and children by 2012, would increase federal outlays by about $900 million in 2008 and by about $14.9 billion over five years.

The main rationale for this option is that it would expand health insurance coverage to low-income parents and their children. In 2005, roughly 40 percent of low-income parents were uninsured. Among parents who would be newly eligible under this option, participation rates would probably be similar to rates among their children who are currently eligible for Medicaid or SCHIP. Coverage for newly eligible parents may boost participation for children currently eligible for Medicaid or SCHIP but not enrolled, since parents and their children would be covered under the same insurance.

A potential drawback of this option is that expanded eligibility could result in some parents with private insurance dropping that coverage to obtain public insurance. Moreover, employers with disproportionate numbers of lower-income workers might be less inclined to offer health insurance to their workforce as a whole because the perceived demand would be lessened by the availability of the new alternative coverage. Also, the increased amounts that states would be required to spend under this option could lead some to cut back on optional health care services that they would otherwise have provided.

RELATED OPTION: 550-9

RELATED CBO PUBLICATIONS: *How Many People Lack Health Insurance and For How Long?* May 2003 (paper); and *How Many People Lack Health Insurance and For How Long?* May 2003 (issue brief)

550-9—Mandatory

Expand Medicaid Eligibility to Young Adults

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	+300	+830	+1,390	+1,780	+1,900	+6,200	+17,550

As a result of expansions to the Medicaid program and enactment of the State Children's Health Insurance Program (SCHIP) in 1997, the majority of children in families with income below 200 percent of the federal poverty level are now eligible for either Medicaid or SCHIP. That coverage based on family income typically ends for young adults when they turn 19, however. And most low-income young adults cannot qualify for public coverage on their own because eligibility is generally limited to parents, disabled adults, and pregnant women; furthermore, income-eligibility requirements for adults are generally more restrictive than they are for children.

This option would require states to expand their Medicaid eligibility to young adults ages 19 to 23 with income below the federal poverty level. That new requirement, which would provide coverage to an estimated 600,000 low-income young adults by 2012, would increase federal outlays by $300 million in 2008 and by $6.2 billion over five years.

A rationale for this option is that it would increase the currently low rates of health insurance coverage for low-income young adults. (In 2005, almost half of those adults were uninsured.) Low-income young adults generally have less access to employer-sponsored health insurance than do other adults because they often work part time or for employers that do not offer coverage. Expanding Medicaid eligibility to that group would increase their access to preventive care and lower the risk of high medical expenditures in the case of unforeseen illness.

An argument against this option is that expanding Medicaid would increase the program's expenditures at a time when it already faces budgetary pressures. Another potential argument against this option is that many young adults are uninsured by choice. (Because low-income young adults tend to be healthier than the overall population, their perceived low risk of having health problems makes them less likely to buy health insurance.) Finally, the increased amounts that states would be required to spend under this option could lead some of them to cut back on optional health care services that they would otherwise provide to their existing Medicaid-covered populations.

RELATED OPTION: 550-8

RELATED CBO PUBLICATIONS: *How Many People Lack Health Insurance and For How Long?* May 2003 (paper); and *How Many People Lack Health Insurance and For How Long?* May 2003 (issue brief)

550-10—Mandatory

Adjust Funding for the State Children's Health Insurance Program to Reflect Increases in Health Care Spending and Population Growth

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	+250	+510	+750	+940	+1,240	+3,690	+13,810
Outlays	+70	+190	+330	+540	+730	+1,860	+11,240

Enacted as part of the Balanced Budget Act of 1997, the State Children's Health Insurance Program (SCHIP) provides health care coverage for certain uninsured children from low-income families. States administer SCHIP through their Medicaid programs, as a separate program, or a combination of both. The program, which began operation in 1998, is authorized through 2007. For the purpose of its baseline budget projections and consistent with statutory guidelines, the Congressional Budget Office assumes that funding for the program in later years will continue at its 2007 level of $5.0 billion. Such funding for SCHIP would gradually cover a progressively smaller proportion of the nation's children because of the rising cost of medical care and the increasing size of the population of children nationwide.

This option would index SCHIP funding after 2007 to the rates of growth in per capita health expenditures—using the projections of national health expenditures (NHE) from the Centers for Medicare and Medicaid Services—and in the number of children. According to the most recent NHE projections, per capita health expenditures will grow by about 6 percent annually after 2007. Those changes would increase SCHIP funding to about $6.8 billion by 2012, raising outlays by $70 million in 2008 and by a total of $1.9 billion through 2012.

This option would reduce, but not eliminate, the shortfalls in funding that many states will face if SCHIP funding continues at its current annual level of $5.0 billion. Under their current allocation of SCHIP funds, a number of states are not receiving sufficient federal money to finance their programs as currently operated. (CBO estimates that 14 states will face a total shortfall of $735 million this year.) In addition, the number of children who are eligible for SCHIP will probably grow more quickly than the overall population of children as the share of people who have private health care coverage continues to gradually decline.

An argument for this option is that without such a funding increase, many states will be unable to maintain their current level of benefits and coverage beyond 2007. (Even with this increase, some states would still face shortfalls in the future.) Many states are already experiencing shortfalls under the current funding levels that cannot be fully addressed by the redistribution of SCHIP funds from states with surpluses. Therefore, to stay within their budget, states will have to reduce the level of benefits they provide to recipients, restrict the number of children deemed eligible for aid, or implement some combination of the two.

An argument against this option is that current funding levels reflect the Congress's intent to establish SCHIP as a program with limited funding. According to that argument, states should design programs with those limits in mind and pay for any additional spending entirely with their own funds. In general, states have flexibility in setting eligibility levels and benefit packages provided under their programs, and they may alter those criteria to reflect the availability of federal and state funds. Some states have even used unspent SCHIP funds for demonstration projects to expand coverage to low-income adults. (The Deficit Reduction Act of 2005 prohibits new SCHIP waivers for nonpregnant, childless adults, however.) It can be argued that SCHIP was intended to cover children and that additional funding need not be provided if some of the program's resources are being used to cover adults.

550-11—Mandatory

Create a Voucher Program to Expand Health Insurance Coverage

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Extend Voucher to Households with Income up to 200 Percent of the Poverty Level							
Change in mandatory spending for subsidy	+2,300	+3,800	+4,900	+5,300	+5,500	+21,800	+51,100
Change in mandatory spending for Medicaid	-120	-250	-390	-540	-700	-2,000	-5,910
Change in revenues	+120	+290	+390	+420	+420	+1,640	+3,680
Extend Voucher to Households with Income up to 300 Percent of the Poverty Level							
Change in mandatory spending for subsidy	+3,100	+5,300	+6,900	+7,500	+7,700	+30,500	+72,300
Change in mandatory spending for Medicaid	-130	-280	-430	-590	-770	-2,200	-6,540
Change in revenues	+160	+380	+550	+590	+630	+2,310	+5,860

More than 30 million people in the United States lacked health insurance throughout 2004, and over 40 million were uninsured on a typical day that year. Three-fourths of adults who are uninsured at a given point in time are employed, but more than half of all uninsured people have income below 200 percent of the federal poverty level. To extend coverage to the uninsured, policymakers have proposed various options, including offering direct subsidies or tax inducements to individuals who purchase coverage or to firms who offer it to their employees; expanding Medicaid and the State Children's Health Insurance Program (SCHIP); changing the rules that regulate private insurance; and requiring employers to offer coverage.

This option would create a voucher that uninsured people could use to purchase coverage in the individual health insurance market. The voucher would pay up to 70 percent of the total cost of insurance premiums in the individual market, not to exceed $1,000 per year for an individual and $2,750 for a family in 2008. (Those amounts would be indexed for inflation in future years.) The Congressional Budget Office considered two alternatives for who would be eligible to receive the voucher. Alternative 1 would include people with household income below 200 percent of the federal poverty level (the value of the voucher would be phased out for people with income between 150 percent and 200 percent of the poverty level). Alternative 2 would include people with household income below 300 percent of the federal poverty level (the value of the voucher would be phased out for people with income between 250 percent and 300 percent of the poverty level). Under either alternative, the voucher would not be taxed as income; would not be available to individuals who were offered insurance through their employer if the employer paid at least 50 percent of the premium; and would not be available to individuals enrolled in Medicare, Medicaid, or SCHIP.

The cost of the subsidy under Alternative 1 would be $2.3 billion in 2008 and $21.8 billion over five years. Of the 6.4 million people using the voucher in 2010, 4.2 million would have already had coverage in the individual health insurance market without the voucher. Providing coverage to that group would account for roughly 65 percent of the cost of Alternative 1 in that year. Of the remaining 2.2 million people, roughly 1.8 million would have otherwise been uninsured, fewer than 200,000 individuals would have been insured through Medicaid, and several hundred thousand would switch from employer-provided coverage to coverage in the individual market.

Approximately 100,000 people would probably become uninsured under Alternative 1 as some small employers elected not to offer insurance because of the new subsidy. Because health insurance in the individual market would become less expensive with the government subsidy, some firms, in CBO's estimation, would opt to provide their employees with higher cash wages rather than offer health insurance. Although such a change might benefit a firm's employees on average, some previously insured employees could face higher premiums in the individual market

(perhaps because of adverse health conditions) and, as a result, might forgo insurance coverage altogether. Those higher cash wages would result in increased revenues of more than $3 billion from income and payroll taxes over the 2008–2017 period.

The subsidy under Alternative 2 would cost $3.1 billion in 2008 and $30.5 billion over five years. Enrollment of formerly uninsured people, at 2.3 million, would be greater than under Alternative 1, while a similar percentage of total subsidy costs would go to people who otherwise (without the subsidy) would have had insurance coverage through the individual market. Also, CBO estimates that about 200,000 individuals who would have been insured through Medicaid would purchase private coverage, and twice as many as under Alternative 1 would switch from their employer-provided coverage to coverage in the individual market. About 200,000 people would become uninsured under Alternative 2, instead receiving higher cash wages from their employer. Overall, under Alternative 2, revenues from income and payroll taxes would grow by nearly $6 billion over the 2008–2017 period.

A rationale for this option is that a lack of health insurance is linked to reduced access to regular, timely health care services, poorer health outcomes, and increased strain on providers such as public hospitals and emergency rooms. Moreover, subsidies for the purchase of insurance in the individual market would work toward balancing the favorable tax treatment currently accorded to employer-provided health insurance and the self-employed.

A potential drawback of this option is that most of the funds would go to eligible people who otherwise would have had insurance coverage even without the subsidy. In addition, although the option would expand health insurance coverage overall, it could reduce coverage rates for a small number of workers whose employers dropped their coverage because of the new subsidy. Finally, the option probably would not increase coverage much for people who do not have access to work-based insurance and are charged high premiums in the individual market because of preexisting or chronic medical conditions.

RELATED CBO PUBLICATIONS: *The Price Sensitivity of Demand for Nongroup Health Insurance,* August 2005; *How Many People Lack Health Insurance and For How Long?* May 2003 (paper); and *How Many People Lack Health Insurance and For How Long?* May 2003 (issue brief)

550-12—Discretionary and Mandatory

Adopt a Voucher Plan for the Federal Employees Health Benefits Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Discretionary Spending[a]							
Budget authority	-100	-500	-1,000	-1,500	-2,000	-5,100	-25,800
Outlays	-100	-500	-1,000	-1,500	-2,000	-5,100	-25,800
Change in Mandatory Spending							
Outlays	-100	-500	-900	-1,300	-1,800	-4,600	-23,400

Note: Estimates do not take into account savings by the Postal Service.

a. Savings measured from the 2007 funding level are adjusted for increases in premiums and changes in employment.

The Federal Employees Health Benefits (FEHB) program provides health insurance coverage to 4 million federal workers and annuitants, as well as to their 4 million dependents and survivors, at an expected cost to the government of almost $25 billion in 2007. Policyholders are required to pay at least 25 percent of the premiums for whatever plan they choose. (As in the private sector, payments for employees' premiums are deducted from pretax income.) That cost-sharing structure encourages federal employees to switch from higher-cost to lower-cost plans to blunt the effects of rising premiums; it also intensifies competitive pressures on all participating plans to hold down premiums. Overall, the federal government's share of premiums for employees and annuitants (including for family coverage) is 72 percent of the weighted average premium of all plans. (The share is higher for Postal Service employees under that agency's collective bargaining agreement.)

This option would offer a flat voucher for the FEHB program that would cover roughly the first $3,600 of premiums for individual employees or retirees or the first $8,400 for family coverage. Those amounts, which are based on the government's average expected contribution in 2007, would increase annually at the rate of inflation rather than at the average weighted rate of change for premiums in the FEHB program. Indexing vouchers to inflation rather than to the growth of premiums would produce budgetary savings because, by the Congressional Budget Office's estimates (based on policies under current law), FEHB premiums will grow three times as fast as inflation. The option would reduce discretionary spending (because of lower payments for current employees and their dependents) by $100 million in 2008 and by a total of $5.1 billion over five years. It would also reduce mandatory spending (because of lower payments for retirees) by $100 million in 2008 and by $4.6 billion over five years.

An advantage of this option is that removing the current cost-sharing requirement would strengthen price competition among health plans in the FEHB program. Because more enrollees would be faced with paying the amount of premiums above the maximum federal contribution, the incentive for them to choose lower-cost plans would increase. Moreover, insurers would have greater incentive to offer more-efficient and lower-cost plans to attract participants, because enrollees would pay nothing for plans costing the same as or less than the amount of the voucher.

This option would have several drawbacks, however. First, the average participant would probably pay more for his or her health insurance coverage. Second, large private-sector companies currently provide better health benefits for employees (although not for retirees) than the government does; that discrepancy would increase under this option, making it harder for the government to attract highly qualified workers. Third, in the case of

current federal retirees and long-time workers, this option would cut benefits that have already been earned. Finally, it could strengthen existing incentives for plans to structure benefits so as to disproportionately attract people with lower-than-average health care costs. That "adverse selection" could destabilize other health care plans.

RELATED OPTION: 550-13

RELATED CBO PUBLICATIONS: *The President's Proposal to Accrue Retirement Costs for Federal Employees*, June 2002; and *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998

550-13—Mandatory

Base Federal Retirees' Health Benefits on Length of Service

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays[a]	*	-20	-30	-45	-60	-155	-770

Note: * = between -$0.5 million and $0.5 million.

a. Estimates do not take into account savings by the Postal Service.

Federal retirees are generally allowed to continue receiving benefits from the Federal Employees Health Benefits (FEHB) program if they have participated in the program during their last five years of service and are eligible to receive an immediate annuity. More than 80 percent of new retirees elect to continue health benefits. For those over age 65, FEHB benefits are coordinated with Medicare benefits; the FEHB program pays amounts not covered by Medicare (but no more than what it would have paid in the absence of Medicare).

Participants in the FEHB program and the government share the cost of premiums. The cost-sharing provision sets the government's share for all enrollees at 72 percent of the weighted average premium of all participating plans (up to a cap of 75 percent of the premium for any individual plan). In 2007, the government expects to pay $8.5 billion in premiums for 1.9 million federal retirees plus their dependents and survivors.

This option would reduce subsidies of premiums for retirees who had relatively short federal careers, although it would preserve their right to participate in the FEHB program. For new retirees only, the government's share of premiums would be cut by 2 percentage points for every year of service fewer than 20. About 14 percent of the roughly 85,000 new retirees who continue in the FEHB program each year have less than 20 years of service. In the case of a retiree with 15 years of service, for example, the government's contribution for that individual would decline from 72 percent of the weighted average premium to 62 percent. Some individuals would retire sooner than planned to avoid the new rule. Hence, the option would have a negligible effect on mandatory spending in 2008—the savings for the FEHB program would be offset by increased outlays for federal pensions—and reduce spending by $155 million over five years. Savings would be lower if the option exempted those retiring on a disability pension.

A rationale for this option is that it would make the government's mix of compensation fairer and more efficient by strengthening the link between length of service and deferred compensation. It would also help bring federal benefits closer to those of private companies. Federal retirees' health benefits are significantly better than those offered by most large private firms, which have been aggressively paring or eliminating retirement health benefits for newly hired workers. According to a 2005 survey by the Kaiser Family Foundations and Health Research and Educational Trust, only about one-third of firms with 200 or more workers offer health benefits for retirees. In 1988, two-thirds of those employers offered coverage. According to other surveys, where medical coverage for retirees is still offered, firms have tightened eligibility rules for new workers, typically requiring 10 or more years of service to qualify.

A disadvantage of this option is that it would mean a substantial cut in promised benefits, particularly for retirees with shorter federal careers, such as the roughly 3 percent of new retirees with 10 years of service or less. The individuals who would face the greatest increases in payments for premiums would include those retiring on disability pensions. In 2005, the disabled represented nearly 60 percent of new retirees with 10 years of service or less. The option could also have unintended and perhaps adverse effects on the composition of the federal workforce by encouraging some employees to retire sooner than planned to avoid the new policy and, in the other direction, inducing others to delay retirement to extend their length of service. Consequently, because of those early departures, the government could have difficulty replacing a sizable number of workers at one time.

RELATED OPTION: 550-12

RELATED CBO PUBLICATIONS: *The President's Proposal to Accrue Retirement Costs for Federal Employees*, June 2002; and *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998

550-14—Discretionary

Reduce Subsidies for the Education of Health Professionals

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-148	-151	-154	-157	-160	-770	-1,618
Outlays	-113	-140	-148	-151	-154	-706	-1,522

Between 2005 and 2006, lawmakers reduced the amount of funding provided to the Health Resources and Services Administration within the Department of Health and Human Services to subsidize institutions that educate physicians and other health care professionals from about $300 million to about $150 million. Those subsidies, which title VII of the Public Health Services Act authorizes, primarily take the form of grants and contracts to schools and hospitals. Several programs offer federal grants to medical schools, teaching hospitals, and other training centers to develop, expand, or improve graduate medical education in primary care specialties and related health care fields and to encourage health care professionals to practice in underserved areas. A few programs provide funding directly to individuals for their education in the health care professions. This option would eliminate those remaining subsidies, saving $113 million in outlays in 2008 and $706 million over five years.

A rationale for this option is that federal subsidies are unnecessary because market forces provide sufficient incentives for people to seek training and jobs in health care. Over the past several decades, the number of physicians—a key group targeted by the subsidies—has increased rapidly. In 2000, for example, the United States had 288 physicians in all fields for every 100,000 people, compared with just 142 in 1960.

In its assessment of the programs, the Office of Management and Budget noted that although the programs are well managed, they do not have a clear purpose in the authorizing legislation. Furthermore, a 1997 report by the General Accounting Office (now the Government Accountability Office) found that the effectiveness of the programs had not been demonstrated, partly because of a lack of appropriate data and clear program objectives.

An argument against this option is that market incentives by themselves may not be strong enough to achieve an optimal number of health care professionals. For instance, third-party reimbursement rates for primary care specialties may not encourage enough physicians to enter those fields or to provide such care in underserved areas.

RELATED OPTIONS: 570-3, 570-5, 570-6, and 570-7

570

Medicare

Medicare, the federal health insurance program for the elderly and some people with disabilities, is divided into three basic programs. Part A, Hospital Insurance, pays for inpatient care in hospitals and skilled nursing facilities. It also pays for some home health care and hospice services. Part B, Supplementary Medical Insurance, pays for physicians' services, hospital outpatient services, some home health care, and other services. Part D, the prescription drug benefit added in 2006, is used to reduce what participants pay for medicine. (Medicare's Part C specifies the rules under which private health care plans can assume responsibility and be paid for providing benefits covered under Parts A, B, and D.)

Total Medicare spending has grown at an average annual rate of about 9 percent in recent years. The Congressional Budget Office estimates that net outlays will total $370 billion in 2007, including discretionary outlays of about $5 billion for Medicare's administrative costs. Roughly $60 billion will be offset by premium payments (mostly from participants in Parts B and D), by payments from states, and by recovery of improper payments to providers. In the next few years, Medicare enrollment—and its cost—will expand substantially as the first members of the baby-boom generation become eligible because of age or disability.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	3.8	3.8	5.4	4.0	4.9	4.8	6.6	-2.5
Outlays								
Discretionary	3.2	3.7	4.5	4.3	5.0	4.9	12.1	-2.5
Mandatory	227.7	245.7	264.9	294.3	324.9	365.3	9.3	12.4
Total	230.9	249.4	269.4	298.6	329.9	370.2	9.3	12.2

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 38 *Expand the Medicare Payroll Tax to Include All State and Local Government Employees*

570-1—Mandatory

Raise the Eligibility Age for Medicare

Under current law, the age at which workers become eligible for full Social Security retirement benefits—the normal retirement age (NRA)—is gradually increasing until it reaches 67 for people who were born in 1960 or later. (Workers can receive a reduced retirement benefit as early as age 62, however.) The eligibility age for Medicare will remain at 65, although people can qualify for coverage earlier if they are disabled or have end-stage renal disease. Because the two programs affect the same population, some people have argued that the eligibility age for Medicare should be identical to Social Security's NRA.

This option comprises two alternatives for raising the eligibility age for Medicare. Each alternative assumes that the eligibility age would not be increased until 2017, so people who are currently nearing retirement would not be affected. The first alternative would increase the eligibility age by two months every year beginning in 2017 until it reached 67 in 2028, where it would stay indefinitely. Although the increases under that alternative are consistent with increases currently scheduled for Social Security's NRA, the Medicare eligibility age would remain below Social Security's NRA until 2028 (because the NRA increases under Social Security started sooner). The second alternative would increase the eligibility age by two months every year beginning in 2017 until it reached 70 in 2046, at which point it would stabilize. That alternative is analogous to the option for raising Social Security's NRA (see Option 650-5), but it would be phased in more slowly and would not raise the eligibility age above 70.

In 2050, Medicare spending would fall by about 3 percent under the first alternative and by about 10 percent under the second. Because those estimates are not within the Congressional Budget Office's 10-year budget window, no year-by-year table is shown. Spending would fall by less than enrollment because younger beneficiaries are healthier and less costly than average.

The reduced spending for Medicare would be partially offset by higher spending under Medicaid and the Federal Employees Health Benefits program—both of which would pick up part of the health care costs of those beneficiaries whose eligibility for Medicare had been delayed. Spending under the military's Tricare For Life program would decline, however, because eligibility for that program is limited to people who are enrolled in Medicare.

The primary rationale for this option is that it would restrain the growth of Medicare spending, which would ease long-term budgetary pressures. Life expectancy has risen since the Medicare program began in 1965, and the life expectancy of 65-year-olds is expected to continue increasing. Therefore, on average, people will spend a longer time covered by Medicare, which will boost the program's costs. In addition, raising the eligibility age would reinforce incentives created by increases in Social Security's NRA for people to delay retirement. Disability among the elderly has declined over time, and jobs are generally less physically demanding, suggesting that a larger fraction of the population may be capable of working past age 65. Many who do so could have access to employment-based insurance.

An argument against this option is that many workers retire before age 65. For those early retirees, raising the eligibility age for Medicare would lengthen the time they might be at risk of having no health insurance. Furthermore, raising the eligibility age for Medicare would shift costs that are now paid by that program to individuals and to employers that offer health insurance to their retirees. Those higher costs might lead more employers to reduce or eliminate health coverage for their retirees. Also, raising the eligibility age for Medicare would strengthen the incentive for people to apply for Social Security disability benefits, reducing the net savings to the federal government.

RELATED OPTION: 650-5

RELATED CBO PUBLICATION: *The Long-Term Budget Outlook,* December 2005

570-2—Mandatory

Set the Benchmark for Private Plans in Medicare Equal to Local per Capita Fee-for-Service Spending

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-8,100	-12,200	-13,700	-16,200	-14,600	-64,800	-159,800

The Medicare Advantage program is the vehicle through which private health plans can participate in Medicare. Plans that want to participate in the program submit bids reflecting the per capita payment for which they are willing to provide Medicare's covered benefits. The government compares those bids with benchmarks that are determined in advance through statutory rules. Plans are paid their bids (up to the benchmark) plus 75 percent of the amount by which the benchmark exceeds their bid. Plans must return that 75 percent to beneficiaries as additional benefits or rebates on their Medicare premium. Plans whose bids are above the benchmark are required to charge enrollees the full difference between the bid and benchmark as an add-on to their regular Medicare premium. (Private plans submit separate bids to provide Medicare's prescription drug benefit; this option pertains to their bids for all other Medicare benefits.)

Benchmarks are established for each county and are required to be at least as high as local per capita spending in Medicare's fee-for-service (FFS) program. (The county-level benchmarks are also used to establish benchmarks for the program for regional preferred provider organizations; see Option 570-4.) In many counties, the benchmark is higher than per capita FFS spending, in some cases substantially. Benchmarks were derived from a payment mechanism for private plans that was established in the Balanced Budget Act of 1997 and modified through subsequent legislation. Those rules resulted in rates in many counties that are higher than local per capita spending in the FFS program.

This option would set the benchmark in each county equal to local per capita Medicare fee-for-service spending. That change would reduce Medicare spending by about $8.1 billion in 2008 and $64.8 billion over five years.

An argument in favor of this option is that the Medicare program should be neutral as to whether beneficiaries decide to enroll in private plans or remain in the fee-for-service sector. (Most beneficiaries—about 82 percent—are enrolled in the FFS program.) The current payment system gives an advantage to private plans because they can operate in areas where their bids exceed FFS spending levels and, if their bids are less than the benchmark, provide additional benefits to attract enrollees. Under that system, Medicare pays more for enrollees in some private plans than it would have paid if they had remained in the FFS sector. Setting the benchmark equal to per capita FFS spending in each county would encourage private plans to operate only in areas where they could provide Medicare services at a lower cost than the FFS sector, without encouraging them to operate in areas where they could not.

An argument against this option is that, in many geographic areas, it would reduce the revenue that private plans receive from Medicare, which could lead many plans to limit the benefits they offer, raise their premiums, or withdraw from the program. Another argument is that private plans should not be expected to provide Medicare services in all markets at a cost that is less than per capita FFS spending because Medicare may be able to use its market power to set FFS payment rates at levels below those that are determined through private-market forces. Below-market payments to health care providers may result in a less-efficient allocation of resources than would be achieved if more beneficiaries were enrolled in private plans that paid providers at rates determined in the market.

RELATED OPTION: 570-3

RELATED CBO PUBLICATION: *CBO's Analysis of Regional Preferred Provider Organizations Under the Medicare Modernization Act,* October 2004

570-3—Mandatory

Remove Medicare's Payments for Indirect Medical Education from the Benchmarks for Private Plans

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-700	-1,000	-1,100	-1,300	-1,100	-5,200	-12,900

Hospitals with teaching programs receive additional payments from Medicare for costs associated with graduate medical education (GME). One component of those additional payments covers the direct costs of GME (such as residents' compensation). Two other components are indirect medical education (IME) adjustments to Medicare's payments for hospitals' operating costs and for their capital-related costs; they are designed to account for the fact that teaching hospitals tend to have greater expenses than other hospitals for various reasons. (For instance, teaching hospitals typically offer more technically sophisticated services and treat patients with more complex conditions than other hospitals do.) Medicare makes those three types of medical education payments to hospitals for the inpatient stays of all Medicare beneficiaries, including those who are enrolled in private health plans that participate in the Medicare Advantage program.

About 18 percent of Medicare beneficiaries are enrolled in Medicare Advantage plans, which assume responsibility and financial risk for providing Medicare benefits. The government's maximum payment, or benchmark, for an enrollee in such a plan is set for each county and updated annually. Benchmarks were derived from a set of payment rates for private plans that were in effect in 2004; under that system, the rate for each county was the greatest of four amounts: a minimum or "floor" rate; a blend of a local rate and the national average rate; a minimum increase from the previous year's rate; and local per capita spending in Medicare's fee-for-service (FFS) program. Beginning in 2005, the benchmark (or rate) in each county is equal to the previous year's benchmark (or rate) updated by the national growth in per capita Medicare spending or by 2 percent, whichever is greater. The government is required to reestimate local per capita FFS spending at least once every three years, and when it does so, the benchmark in each county is the greater of that new estimate of local FFS spending or the previous year's benchmark updated in the usual manner.

The estimates of local per capita FFS spending in 2004 and the revised estimates generated in later years include payments for IME even though the Medicare program makes IME payments directly to teaching hospitals for the inpatient stays of Medicare Advantage enrollees. As a result, the Medicare program is paying twice for IME for those enrollees—first, as an allowance for IME payments in the benchmark and, second, as a payment to teaching hospitals.

This option would remove payments for IME from the benchmarks for private plans, leaving the payment to teaching hospitals as the only compensation for IME. Making that change would reduce Medicare outlays by $700 million in 2008 and by $5.2 billion through 2012.

A rationale for this option is that it would reduce Medicare expenditures. According to proponents, there is no basis for making double payments for IME for Medicare Advantage enrollees.

A potential drawback of this option is that eliminating the double payment for IME would reduce the revenue that private health plans earn from Medicare, which could lead some plans to limit the benefits they offer, raise their premiums, or withdraw from the program. Plan withdrawals could reduce the number of Medicare beneficiaries with access to private health plans and the additional benefits they provide.

RELATED OPTION: 570-2

570-4—Mandatory

Eliminate the Stabilization Fund for Medicare's Regional PPO Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	0	0	-1,550	-1,550	-3,490

The Medicare Modernization Act of 2003 (MMA) established incentives for preferred provider organizations (PPOs) to participate in Medicare and serve broad regions of the country. One of those incentives is a stabilization fund that the Medicare program may use to increase the maximum payment amounts (or benchmarks) for regional PPOs to encourage them to enter into and remain in the Medicare Advantage program. Regional PPOs, like other types of Medicare Advantage plans, submit bids reflecting the per capita payment for which they are willing to provide Medicare's covered benefits. The plans are paid their bids (up to the benchmark) plus 75 percent of the amount by which the benchmark exceeds their bid. Plans must return that 75 percent to beneficiaries as additional benefits or as rebates on their Part B or Part D premiums. Plans whose bids are above the benchmark are required to charge enrollees the full difference between the two amounts as an additional premium for the Medicare benefit package.

The benchmarks for regional PPOs are a weighted average of two components: a statutory component and a bid component. The statutory component is the weighted average of the county-level benchmarks in the region, with each county weighted by the number of Medicare beneficiaries who live there. (The county-level benchmarks are determined each year by statutory rules. They are required by law to be at least as high as per capita fee-for-service spending in the county; in many counties, they are higher than such spending.) The bid component is a weighted average of the bids of the PPOs in the region, with each PPO weighted by its enrollment. To determine the regional benchmark, the statutory component is weighted by the number of Medicare beneficiaries nationally who are enrolled in the fee-for-service program, and the bid component is weighted by the number who are enrolled in private plans. (In contrast, for all other types of Medicare Advantage plans, the benchmark is the weighted average of the county-level benchmarks in the plan's service area, with each county weighted by the number of the plan's enrollees who live there. The plans' bids do not affect their benchmarks.)

The MMA established the stabilization fund for the regional PPO program and mandated that $10 billion be available to the fund from 2007 through 2013. The Tax Relief and Health Care Act of 2006 reduced the amount of money that will be available to the fund to $3.5 billion and limited the period during which it can be used to 2012 and 2013. The fund will also receive a portion (12.5 percent) of the difference between the bids of regional PPOs and their benchmarks when those bids are below the benchmarks. The Medicare program can use the stabilization fund to increase the benchmarks in regions that were not served by regional PPOs in the previous year and, under certain conditions, to increase the benchmarks in regions in which PPOs inform the government that they intend to leave the program. The stabilization fund can also be used to increase the benchmarks for organizations that participate in every region.

This option would eliminate the stabilization fund for the regional PPO program. Because no money will be available to the fund until 2012, this option would have no effect on Medicare spending until that year. It would reduce Medicare spending by $1.6 billion in 2012 and by $3.5 billion over 10 years.

An argument in favor of this option is that the stabilization fund could give regional PPOs an advantage relative to other plans that participate in Medicare Advantage. In addition, the evidence suggests that increased benchmarks may not be necessary to encourage regional PPOs to participate in Medicare—such plans participated in 21 of the 26 regions in 2006, with no payment from the fund.

An argument against this option is that it could decrease the number of regional PPOs that participate in Medicare and reduce the number of regions that are served by such plans. Without the increased benchmarks, PPOs may not

be willing to participate in some regions, particularly those that are largely rural. (Health plans typically find it more costly to develop provider networks in rural areas because of the lack of competition among providers there.) Consequently, elimination of the stabilization fund could reduce the number and types of private plans that are available to Medicare beneficiaries; as a result, the additional benefits and premium rebates that many plans offer might be reduced or eliminated for beneficiaries in some areas.

RELATED CBO PUBLICATION: *CBO's Analysis of Regional Preferred Provider Organizations Under the Medicare Modernization Act,* October 2004

570-5—Mandatory

Reduce Medicare's Payments for the Direct Costs of Medical Education

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-900	-1,200	-1,200	-1,300	-1,300	-5,900	-12,700

Medicare pays hospitals for the inpatient stays of its beneficiaries through a prospective payment system. Under that system, hospitals with teaching programs receive additional amounts for costs associated with graduate medical education (GME). One component of the education-related payment is called direct GME, which covers a portion of a hospital's costs for residents' compensation and institutional overhead. Payments are made on the basis of a hospital's 1984 cost per resident (indexed for changes in consumer prices) and Medicare's share of inpatient days. Direct GME payments for physician residents, received by about one-fifth of U.S. hospitals, totaled $2.3 billion in 2006. (Option 570-6 covers Medicare's indirect payments for medical education.)

Under this option, hospitals' direct GME payments would be set at 120 percent of the national average salary paid to residents in 1987 and updated annually for changes in consumer prices since 1987. In effect, this option would reduce payments for teaching and overhead while continuing payments for residents' compensation. It would also maintain the current practice of reducing payments for residents who have exceeded their initial period of residency. (Such a resident is treated as one-half of a full-time-equivalent resident.) The savings from this option would total $900 million in 2008 and $5.9 billion over five years.

An argument in favor of this option is that market incentives appear sufficient to entice people to enter medicine, so a reduction in the federal subsidy for medical education may be warranted. In addition, because hospitals benefit from the services that residents provide, they should shoulder more of the costs of residents' training. Although residents would bear more of the cost of their education if hospitals responded by cutting residents' salaries or benefits, the training ultimately enables them to earn higher future incomes.

An argument against this option is that reducing the federal subsidy for graduate medical education could lead some hospitals to cut the resources they devote to medical training, possibly compromising the quality of their education programs.

570

RELATED OPTIONS: 550-14, 570-6, and 570-7

RELATED CBO PUBLICATION: *Medicare and Graduate Medical Education,* September 1995

570-6—Mandatory

Reduce Medicare's Payments for the Indirect Costs of Patient Care Related to Hospitals' Teaching Programs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-3,900	-4,100	-4,300	-4,500	-4,800	-21,600	-51,200

Under Medicare's prospective payment system for inpatient medical services, hospitals with teaching programs receive additional funds for costs related to graduate medical education (GME). One part of the additional payment to teaching hospitals covers the costs of indirect medical education (IME), or those costs that are not attributable either to residents' compensation or to other direct costs of running a teaching program. Examples of IME expenses are the added demands placed on staff as a result of teaching activities and the greater number of tests and procedures ordered by residents. IME payments also compensate for the higher proportion of severely ill patients treated at teaching hospitals. (Option 570-5 discusses direct GME payments.)

The IME adjustment provides teaching hospitals with about 5.5 percent more in payments for inpatient services for every increase of 0.1 in the ratio of full-time residents to the number of beds. (The adjustment for 2007 is 5.35 percent.) This option would lower the IME adjustment to 2.2 percent—an amount that the Medicare Payment Advisory Commission has estimated would more accurately reflect indirect costs—saving $3.9 billion in 2008 and $21.6 billion through 2012.

An argument in favor of this option is that it would bring payments into line with actual teaching costs, thus reducing the federal subsidy without unduly affecting teaching activity. It also would remove an incentive for hospitals to have a higher number of residents than is necessary.

Possible drawbacks of this option are that a lower teaching adjustment could prompt teaching programs to train fewer residents or devote less time and resources to beneficial educational activities. Also, because some teaching hospitals use a portion of the additional payments they receive to fund charitable care, reducing those payments could limit the number of low-income patients they were able to serve or decrease the quality of care they were able to provide.

RELATED OPTIONS: 550-14, 570-5, and 570-7

RELATED CBO PUBLICATION: *Medicare and Graduate Medical Education,* September 1995

570-7—Mandatory

Equalize Medicare's Capital-Related Payments for Teaching and Nonteaching Hospitals

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-400	-400	-500	-500	-500	-2,300	-5,300

Under the prospective payment system for inpatient hospital services, Medicare pays hospitals an amount for each discharged patient that is intended to compensate hospitals for capital-related costs such as depreciation, interest, rent, and other expenses related to property. Hospitals with teaching programs receive additional capital-related payments that are made on the basis of "teaching intensity," which is measured as the ratio of residents to the average daily number of hospitalized patients. An increase of 0.1 in that ratio raises a hospital's capital-related payment by 2.8 percent.

This option would eliminate those extra payments to teaching hospitals, saving the Medicare program $400 million in 2008 and $2.3 billion over five years.

One argument in favor of this option is that paying teaching hospitals more than nonteaching hospitals for treating otherwise similar patients may promote inefficient practices at teaching hospitals. In addition, Medicare's payment adjustments for teaching intensity may distort the market for residency training by artificially increasing the value (or decreasing the cost) of residents to hospitals. According to that argument, if residents' training raised the costs of patient care for a hospital, the hospital should bear those costs in order to encourage an efficient amount of training. Finally, although residents would bear more of the cost of their education if hospitals responded by cutting their salaries or benefits, their training would still enable them to eventually earn a high income.

A possible drawback of this option is that it could prompt teaching programs to train fewer residents or to devote less time and resources to beneficial educational activities. Also, because some teaching hospitals use a portion of their additional payments to fund charity care, reducing those payments could limit the number of low-income patients they were able to serve or decrease the quality of care they were able to provide.

570

RELATED OPTIONS: 570-5 and 570-6

RELATED CBO PUBLICATION: *Medicare and Graduate Medical Education,* September 1995

570-8—Mandatory

Convert Medicare's Disproportionate Share Hospital Payments into a Block Grant

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,200	-1,700	-2,200	-2,700	-3,400	-11,200	-40,300

Hospitals that serve a disproportionately large number of low-income patients can receive higher payment rates under Medicare than other hospitals do. The Medicare disproportionate share hospital (DSH) adjustment was introduced in 1986 to account for what were assumed to be the higher costs of treating Medicare patients in such hospitals. The DSH adjustment has also come to be seen as a way to protect low-income patients' access to care by providing financial support to hospitals that serve a large share of people from low-income populations.

Between 1992 and 1997, annual outlays for Medicare DSH payments rose from $2.2 billion to $4.5 billion. Restrictions established by the Balanced Budget Act of 1997 caused those outlays to decline for a few years, but they resumed growing in 2000. In 2003, the Medicare Modernization Act further boosted DSH payments to rural and small urban hospitals by adjusting the payment formulas. As a result, Medicare DSH payments totaled $9.5 billion in 2006.

This option would convert DSH payments into a block grant to the states. In 2008, each state's grant would be 10 percent less than the estimated sum of Medicare DSH payments made to hospitals in that state in 2006. In subsequent years, the block grant would be indexed to the change in the consumer price index for all urban consumers minus 1 percentage point. In return for the lower Medicare DSH payments, states would be granted increased flexibility in how they used their DSH funds. Those changes would decrease Medicare outlays by $1.2 billion in 2008 and by $11.2 billion over five years. (The estimated savings include the lower payment updates that plans participating in the Medicare Advantage program would receive.)

An argument in favor of this option is that the added flexibility provided to states under this option could result in DSH funds being targeted more appropriately and equitably to facilities and providers that serve low-income populations. For example, rather than going solely to hospitals, such funds might also be used to support outpatient clinics that treat low-income patients.

An argument against this option is that the net reduction in federal payments to hospitals, unless made up for by states with their own funds, would result in some hospitals' receiving less public funding than they do now. That drop in funding could limit the number of low-income patients they were able to serve or decrease the quality of care they were able to provide.

RELATED OPTION: 550-6

570-9—Mandatory

Reduce the Update Factor for Hospitals' Inpatient Operating Costs Under Medicare

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,000	-2,200	-3,400	-4,800	-6,400	-17,800	-80,200

Medicare compensates hospitals for their operating costs tied to providing inpatient services to Medicare beneficiaries under a prospective payment system (PPS). Payments are determined on a per-case basis, according to preset rates that vary with a patient's diagnosis and the characteristics of the hospital. Medicare adjusts those payment rates each year using an update factor that is determined in part by the projected rise in the hospital market-basket index (MBI), which reflects increases in hospitals' costs per case or their unit costs.

Under current law, hospitals that submit quality performance data each year to the Department of Health and Human Services will receive the full MBI update for that year. Hospitals must report on a set of measures approved by the Hospital Quality Alliance (HQA). The current set of measures—which is continuously being expanded by the HQA—reflects recommended treatments for three serious medical conditions (heart attack, heart failure, and pneumonia) and guidelines for patient safety (such as the prevention of surgical infection). Hospitals that do not submit the required information will receive the MBI update factor minus 2 percentage points. That reduction will apply only for the year in which the hospital does not submit the required information and will not be taken into account in subsequent years. (The Congressional Budget Office expects that nearly all hospitals will submit the required data and receive the full update.)

This option would reduce the Medicare PPS update factor set under current law by 1 percentage point. That lower rate would take effect in 2008 and continue through at least 2017. Savings from this option would total $1 billion in 2008 and $17.8 billion over five years.

Supporters of this option reason that granting the full MBI update factor will overcompensate hospitals for their average growth in operating costs. To the extent that the MBI is intended to approximate how much providers' costs would rise if the quantity, quality, and mix of inputs they use to provide care remained constant, the MBI would generally overstate cost inflation because of productivity improvements (such as the tendency of providers to adopt cost-saving technological advances in response to the fixed payments established under the PPS).

Critics of this option contend that Medicare's payments for inpatient services should not be reduced without carefully evaluating the adequacy of payments for other hospital services (such as outpatient care). The overall Medicare margin (which includes both inpatient and outpatient care) has decreased continuously since 2000 (falling to -3 percent in 2004), and further reductions in the update factor could cause considerable hardship for hospitals.

RELATED OPTION: 570-10

570-10—Mandatory

Reduce Medicare's Payments for Hospitals' Inpatient Capital-Related Costs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-400	-500	-500	-500	-500	-2,400	-5,600

In 1992, Medicare changed its method of paying hospitals for capital expenses associated with providing inpatient services; specifically, it switched from a cost-based reimbursement system to a prospective payment system. Under the revised system, hospitals receive a predetermined amount to cover capital-related costs for every Medicare patient treated at their facility. (Those costs include depreciation, insurance, interest, taxes, and similar expenses for the maintenance of buildings and the purchase and upkeep of equipment.) The prospective payment system for capital-related costs applies to hospitals that are also reimbursed by Medicare for inpatient operating costs under that system. A hospital's payment rate is adjusted to reflect its case mix of patients and other characteristics, such as whether the hospital is new and where it is located.

Analyses by the Centers for Medicare and Medicaid Services (CMS), which administers the Medicare program, suggest that the rates for capital payments set in 1992 were too high. Those rates were based on 1989 data projected to 1992; but in actuality, capital costs grew more slowly than expected during those years. Moreover, the level of capital costs per case that was used to set rates in 1989 was probably higher than would be optimal because of incentives created under cost-based reimbursement before 1992. Factors such as changes in capital prices, the mix of patients treated at a given hospital, and the "intensity" (technological complexity) of hospital services contributed to the inflated estimates for the initial capital rates set in 1992, which the Medicare Payment Advisory Commission and CMS calculated were between 15 percent and 28 percent, with an average of about 22 percent. In response, as part of the Balanced Budget Act of 1997, lawmakers reduced by 17.8 percent the federal rate for capital payments made to hospitals for patient discharges occurring between 1998 and 2002. (A small part of that reduction, 2.1 percentage points, was restored effective October 1, 2002.)

This option would further reduce the prospective payment rate for hospitals' capital-related costs by 5 percentage points. That change would lower Medicare outlays by $400 million in 2008 and $2.4 billion through 2012.

A rationale for this option is that it would reduce the overestimate that might remain in Medicare's capital payment rates. Moreover, since Medicare's payments for capital-related costs represent a small share—about 5 percent—of hospitals' total revenues, most hospitals would probably be able to adjust to the reductions by lowering their capital costs or by partially covering those expenses through other sources of revenue.

An argument against this option is that hospitals in poor financial condition could have difficulty absorbing the reductions. As a result, the quality of the care that they offered could decline, and they might provide fewer services to people without health insurance.

RELATED OPTION: 570-9

570-11—Mandatory

Reduce Medicare's Payments for Home Health Care

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-300	-900	-1,600	-2,400	-3,300	-8,500	-33,100

In 2006, Medicare paid about $13 billion for home health care services (which include skilled nursing care, physical and speech therapy, and home health aide services for beneficiaries deemed to be homebound). Medicare spending on home health services grew rapidly in the late 1980s and early 1990s, when home health agencies were reimbursed separately for each home health visit, but it fell sharply after a new payment system was implemented under the Balanced Budget Act of 1997. Since 2000, however, Medicare spending on home health care has again been increasing rapidly.

Home health agencies currently receive a single payment from Medicare for providing all covered services to an individual beneficiary for a 60-day period (known as a home health episode). The Centers for Medicare and Medicaid Services sets the payment rates for different types of episodes prospectively, meaning that payment rates are set in advance to reflect the expected costs of each episode and are not determined by the costs that home health agencies actually incur. In calendar year 2007, the base payment rate per home health episode is $2,339. Under current law, that rate is updated from year to year, partly on the basis of annual changes in the prices of inputs (such as wages for home health aides).

The Medicare Payment Advisory Commission, or MedPAC, has calculated that among freestanding home health agencies, the aggregate Medicare margin—the excess of Medicare payments over providers' costs expressed as a percentage of payments—was high in 2004, at about 16 percent. (MedPAC did not report the aggregate Medicare margin for hospital-based agencies in 2004.) MedPAC projects that the aggregate Medicare margin will remain at a high level (15 percent) in 2006, even though the Deficit Reduction Act of 2005 eliminated the 2006 update for home health agencies. The continuing high margins appear to be the result of reductions in home health agencies' costs in response to the incentives created by the new prospective payment system.

This option would freeze the base payment for each home health episode under Medicare at its calendar year 2007 level ($2,339) through 2012, with the goal of gradually narrowing the gap between payments and costs. That change would reduce federal outlays by $300 million in 2008 and by $8.5 billion over five years.

A rationale for this option is that margins for home health care are likely to remain high under current law. MedPAC estimates that home health agencies' costs per episode have grown by less than 1 percent a year in recent years, and if that trend continues, home health agencies would still receive more than adequate margins under this option.

A drawback of this option is that it could reduce access to home health services for Medicare beneficiaries. Home health agencies that had substantially higher costs than average and that were not able to reduce their operating expenses sufficiently would cease participating in the program. As a result, some beneficiaries might have difficulty obtaining home health services. Also, although MedPAC has not thus far identified problems with the quality of care provided under the new payment system, lower payment rates could lead some home health agencies to reduce the level or quality of the services they provide.

RELATED OPTION: 570-12

570-12—Mandatory

Reduce the Payment Update Factors for Providers of Post-Acute Care Under Medicare

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-350	-900	-1,500	-2,250	-3,050	-8,050	-40,350

Medicare's coverage of post-acute care is generally limited to patients who require skilled nursing care or rehabilitation. Post-acute care is offered by four types of providers: skilled nursing facilities, home health agencies, long-term care hospitals, and inpatient rehabilitation facilities. In 2004, Medicare outlays for post-acute care accounted for over 12 percent of total Medicare spending. In each of the four post-acute care settings, providers are paid by Medicare under prospective payment systems in which payment rates reflect "base" payment rates. The payment for a specific case equals the base payment rate adjusted to reflect local practice costs, the clinical characteristics of the patient, and other factors.

Annual increases in Medicare's base payment rates are referred to as "update factors." Under current law, update factors generally are determined by increases in the prices of various "inputs," such as labor and equipment, that medical providers use to produce medical services. Those increases in input prices are measured by market-basket indexes, which combine various price increases into a single number for each type of provider.

This option would change the update factors for each type of post-acute care provider to equal the market basket index minus 1 percentage point for each year beginning in 2008. This option would reduce Medicare outlays by $350 million in 2008 and by $8.1 billion over five years.

An argument in favor of this option is that Medicare's payment rates for post-acute care have been found, in general, to be more than adequate relative to providers' costs. The Medicare Payment Advisory Commission (MedPAC) came to that conclusion in its March 2006 report to the Congress. MedPAC recommended that the Congress eliminate the update to payment rates for all types of post-acute care providers for 2007 and stated that doing so would be unlikely to harm beneficiaries' access to post-acute care. A second argument for this option is that it could provide a stronger incentive for post-acute care providers to increase their efficiency and reduce their operating costs.

An argument against this option is that the reduced federal payments that would result might increase the incentive of post-acute care providers to avoid admitting to their facilities patients with complex conditions who require costly care. Reducing update factors, therefore, might lead to certain patients having difficulty obtaining post-acute care. To the extent that patients faced limited access to post-acute care, they might either remain longer in a short-stay hospital, return home without receiving post-acute care, or be discharged to receive long-term care not covered by Medicare. By reducing the revenue of providers, this option might also limit their ability to provide high-quality care.

RELATED OPTION: 570-11

570-13—Mandatory

Modify the Sustainable Growth Rate Formula for Setting Medicare's Physician Payment Rates

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Outlays							
Increase physician payment rates by 1 percent in 2008	+2,800	+5,280	+5,270	+5,280	+5,340	+23,970	+39,450
Increase physician payment rates by 1 percent in 2008 and treat the update as a change in law or regulation	+2,800	+5,280	+5,270	+5,280	+5,340	+23,970	+53,000
Increase physician payment rates by 1 percent in 2008 and include a hold-harmless provision for premiums	+3,570	+6,760	+6,740	+6,760	+6,840	+30,670	+50,520
Replace the sustainable growth rate mechanism with annual updates based on the Medicare economic index	+3,180	+8,700	+12,940	+17,600	+22,580	+65,000	+261,820

Each year, according to federal law, Medicare sets fees for physicians' services using the "sustainable growth rate" (SGR) mechanism. That mechanism establishes both yearly and cumulative targets for Medicare's combined spending for physicians' services and those services furnished "incident to" (in connection with) a visit to a physician (for instance, diagnostic laboratory services or physician-administered drugs). Those targets are updated annually to reflect inflation, overall economic growth, the increase in the number of Medicare enrollees in the fee-for-service sector, and any changes in Medicare outlays that stem from new laws or regulations. If spending exceeds the target (measured on both an annual and a cumulative basis), as it currently does, the SGR mechanism is designed to reduce payment rates to physicians each year so that cumulative spending and the cumulative target eventually converge. (The reverse happens when spending is below the target.)

Since 2002, Medicare spending for physicians' services has consistently been above the targets established by the formula and, consequently, the SGR mechanism has called for reductions in physician payment rates. In 2003, physicians were scheduled to receive a negative 4.4 percent update, after having seen a drop in payment rates of 4.8 percent in 2002. Lawmakers responded to that imminent reduction by boosting the cumulative target, thereby producing a 1.6 percent increase in payment rates for physicians' services for 2003. Since 2003, legislation has overridden scheduled payment reductions each year, further widening the gap between the target for cumulative spending and actual cumulative spending. As a consequence, unless overridden by legislation again, payment rates under the SGR mechanism will be reduced by about 10 percent in 2008 and around 5 percent annually for at least several years thereafter.

Given that the SGR formula's results have been overridden in each of the past five years, there is interest among policymakers in considering other payment mechanisms. The option considered here presents four alternatives, three of which would adjust the SGR mechanism to provide temporary relief from projected payment cuts and one that would repeal the SGR mechanism and instead increase payment rates each year by the Medicare economic index, or MEI.

- Alternative 1 would increase physician payment rates by 1 percent in 2008 but *would not* treat the update as a change in law or regulation. As a result, the SGR expenditure targets would remain the same, and the difference between cumulative actual spending and the cumulative expenditure targets would be larger than under current law. The increase in spending attributable to the higher payment rate under this alternative would eventually be recouped by the SGR,

causing payment rates to be lower in the future than they would otherwise have been. This alternative would increase net federal outlays by $2.8 billion in 2008 and by $24.0 billion over the 2008–2012 period.

- Alternative 2 would increase payment rates by 1 percent in 2008 and *would* treat the update as a change in law or regulation. Thus, the SGR would be adjusted to account for the increased payment rate, and the difference between cumulative actual spending and the cumulative target would be largely unchanged from what it was under current law. This alternative would increase net federal outlays by $2.8 billion in 2008 and by $24.0 billion through 2012. (Because the Congressional Budget Office's baseline assumes that the maximum cuts are effective for at least the next several years, Alternatives 1 and 2 change outlays equally over the 2008–2012 period. However, Alternative 2 would cost more than Alternative 1 over the full 10-year period.)

- Alternative 3 is largely the same as Alternative 1, but it would include a provision specifying that Medicare's Part B premium would not be adjusted to reflect changes in spending resulting from changes in payment rates for physicians' services. Because that hold-harmless provision would uncouple premiums from program costs, this alternative would increase federal costs relative to their projected level under Alternative 1. In particular, this alternative would boost net federal outlays by $3.6 billion next year and by $30.7 billion over five years.

- Alternative 4 would fully replace the SGR targets with annual updates based on changes in the prices of inputs that are used to provide physicians' services, minus a productivity adjustment (as measured by the Medicare economic index). Instead of declining by about 10 percent in 2008 and around 5 percent annually for at least several years thereafter, payment rates would climb by about 2 percent annually. Those updates would not be subject to further adjustments, and excess spending, as defined by the SGR, would not be recouped. This alternative would increase net federal outlays by $3.2 billion in 2008 and by $65.0 billion from 2008 to 2012.

An advantage of all the alternatives is that replacing the 2008 projected negative update with a positive update (either a 1 percent update in Alternatives 1, 2, and 3 or an MEI-based update in Alternative 4) could forestall the possibility that beneficiaries might find it harder to locate a physician who accepts Medicare patients. (Several organizations have examined that issue, including the Government Accountability Office, the Medicare Payment Advisory Commission, and the Center for Studying Health System Change. Although they have not identified problems with Medicare beneficiaries' current access to care, it is uncertain at what point changes in physicians' participation because of lower fees would have a significant negative effect on Medicare patients' access to physicians' services.)

The first three alternatives, which would preserve the current SGR mechanism for updating payments for physicians' services, would temporarily lift the fee reductions scheduled under the SGR mechanism with the expectation that future payment rates would be reduced to recoup spending already incurred that exceeded the SGR targets. A rationale for preserving the SGR mechanism (as in Alternatives 1, 2, and 3) is that failing to recoup past excess spending under the SGR mechanism and increasing fees paid to physicians would add to the already substantial long-term costs of the Medicare program and to the broader budgetary pressures posed by the aging of the baby-boom generation.

Proponents of replacing the SGR mechanism (as in Alternative 4) argue that the current system is flawed because as a national target, it does not provide incentives for individual physicians to control the volume of services they provide. In addition, the SGR mechanism cannot differentiate between increases in the volume of physicians' services that are desirable (for example, for preventive care) and increases that are not.

An argument against modifying the SGR mechanism according to all of the alternatives considered here is that over the long term, higher spending by Medicare for physicians' services would boost federal spending, requiring cuts elsewhere in the budget, higher taxes, or larger deficits. In addition, because all of the alternatives to the current SGR formula result in higher Medicare spending, beneficiaries would face higher cost-sharing obligations and (except under Alternative 3) higher Medicare Part B premiums, which are set at 25 percent of the program's average costs.

RELATED CBO PUBLICATIONS: *The Sustainable Growth Rate Formula for Setting Medicare's Physician Payment Rates,* September 7, 2006; and testimony on *Medicare's Physician Payment Rates and the Sustainable Growth Rate,* July 25, 2006

570-14—Mandatory

Limit General-Revenue Medicare Funding to 45 Percent

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	0	0	0	0	-91,000

The Medicare Modernization Act of 2003 (MMA) included a provision designed to limit Medicare's total outlays relative to its "dedicated financing sources," which include the Hospital Insurance payroll tax revenue and premiums paid by beneficiaries. That provision directs the Medicare trustees to calculate and report their projection of the general-revenue Medicare funding (GRMF) percentage, which equals total Medicare outlays minus dedicated Medicare financing as a percentage of total Medicare outlays. If the Medicare trustees report that the GRMF share will exceed 45 percent in one or more of the next seven years, then they are required to make a determination of "excess general revenue Medicare funding." If the trustees make such a determination in two consecutive years, the MMA requires the President to submit legislation designed to eliminate the excess general-revenue funding, and it establishes expedited procedures for considering legislation with that objective.

In their 2006 report, the Medicare trustees projected that the GRMF percentage would exceed 45 percent in 2012 and in all years thereafter. If the trustees make a second such determination in their 2007 report, the President would be required to propose legislation to address the excess. The GRMF percentage could be reduced in three ways: by reducing Medicare outlays, increasing Medicare's payroll tax revenues, or raising the premiums paid by beneficiaries for Parts B and D of Medicare.

This option would institute an automatic mechanism to reduce Medicare payments to fee-for-service providers across the board so that the GRMF percentage would not exceed 45 percent in any year from 2008 through 2017. It would apply to all payments that are made on the basis of a fee schedule, which includes payments to hospitals, physicians, and providers of post-acute care. The reductions in fee-for-service payment rates also would indirectly reduce Medicare's payments to private Medicare Advantage plans by reducing the so-called benchmark payment rates.

Because the Congressional Budget Office projects that the GRMF percentage will not exceed 45 percent until 2014, this option would have no effect on Medicare spending until that year. In 2014, Medicare spending would decline by $5.1 billion. Over 10 years, Medicare spending would fall by $91.0 billion.

An argument in favor of this option is that it would reduce the federal government's Medicare outlays compared with their level under current law. Reductions in Medicare's Part B expenditures would also reduce beneficiaries' premiums and out-of-pocket payments.

An argument against this option is that, once the payment reductions take effect, Medicare beneficiaries might face difficulties obtaining access to medical services if providers became less willing to serve them. Because providers would receive less revenue from Medicare, they would either have to reduce their operating costs or earn lower margins on Medicare patients. By reducing the revenue of providers, this option might also limit their ability to provide high-quality care. In addition, reductions in Medicare's payments to Medicare Advantage plans would result in beneficiaries' paying higher premiums for those plans or receiving a narrower benefit package, and some plans might withdraw from the Medicare program.

570-15—Mandatory

Increase the Basic Premium for Supplementary Medical Insurance to 30 Percent of the Program's Costs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-6,760	-7,670	-8,710	-9,370	-9,650	-42,160	-102,200

Medicare's Supplementary Medical Insurance (SMI) program, or Part B, allows beneficiaries to obtain coverage for physicians' and other outpatient services by paying a monthly premium ($93.50 in 2007). The premium was originally intended to finance 50 percent of the SMI program's costs, with the remainder funded from general revenues. Legislation enacted in 1972, however, limited growth in the SMI premium to the Social Security cost-of-living adjustment (COLA), and the premium's share subsequently fell below 25 percent of the program's costs because medical spending grew more quickly than inflation. After setting the premium's share at 25 percent during much of the 1980s, the Congress passed the Omnibus Budget Reconciliation Act of 1990, which specified dollar amounts for 1991 through 1995; but when per capita health care spending grew more slowly than anticipated, the premium's share of the program's costs rose to more than 31 percent. The Balanced Budget Act of 1997 permanently set the Part B premium at 25 percent of SMI spending. General revenues still fund the remainder. (Since January 2007, some higher-income enrollees have faced greater premiums for Part B, but the basic premium of 25 percent still applies to about 96 percent of enrollees; the "income-related" SMI premium is described in Option 570-16.)

This option would raise the basic SMI premium to 30 percent of the program's costs starting in 2008 while preserving the income-related-premium shares specified in current law, saving $6.8 billion in 2008 and $42.2 billion over five years. The estimate assumes a continuation of the hold-harmless provision, which protects SMI enrollees (other than those paying the income-related premium) from a drop in their monthly net Social Security benefits when the premium increase exceeds Social Security's COLA. The hold-harmless provision would apply to more enrollees in 2008 because of the initial increase in premiums from 25 percent to 30 percent under this option.

The main rationale for this option is that it would ease the budgetary pressures posed by rising SMI costs, which are expected to accelerate as the baby-boom generation ages. Even under this option, the public subsidy for most SMI enrollees would remain quite high, at 70 percent—a subsidy far greater than what was intended at the program's outset. Moreover, because Medicaid pays the SMI premiums for certain low-income Part B enrollees with limited assets, those people would be unaffected.

An argument against this option is that it would reduce disposable income for many SMI enrollees below what it would be otherwise. In addition, expenditures for states would rise if they paid higher premiums for people eligible for coverage through both Medicare and Medicaid.

RELATED CBO PUBLICATION: *The Long-Term Budget Outlook,* December 2005

570-16—Mandatory

Increase the Fraction of Medicare Beneficiaries Who Pay an Income-Related Premium for Supplementary Medical Insurance

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Eliminate inflation adjustments to income thresholds after 2008	0	-300	-700	-1,000	-1,300	-3,300	-16,300
Reduce 2008 income thresholds by 20 percent	-600	-1,400	-1,700	-2,100	-2,400	-8,200	-25,400

Medicare's Supplementary Medical Insurance (SMI) program, or Part B, offers subsidized coverage for physicians' and other outpatient services. Before 2007, one SMI premium applied universally to all beneficiaries. Beginning in January 2007, however, the SMI premium is tied to enrollees' modified adjusted gross income (AGI). Although the premium for most beneficiaries will remain at 25 percent of SMI costs per aged enrollee, those in higher income categories will face progressively greater shares of 35 percent, 50 percent, 65 percent, and 80 percent, to be phased in over three years. For 2007, the income categories are defined using the following thresholds: $80,000, $100,000, $150,000, and $200,000. (For married couples, the corresponding income thresholds are twice the values shown.) Those thresholds are set to rise annually with changes in the consumer price index for urban consumers.

This option would apply the higher SMI premiums to more beneficiaries by one of two methods. Alternative 1 would eliminate the scheduled inflation adjustments to the income thresholds after 2008. Alternative 2 would reduce each 2008 income threshold by 20 percent while retaining the scheduled adjustments for inflation. As under current law, only those enrollees who pay the basic 25 percent premium would be covered by the hold-harmless provision, which ensures that the amount of an enrollee's Social Security check does not decline if the cost-of-living adjustment is insufficient to cover an increase in the SMI premium resulting from the annual update. Alternative 1 would not reduce outlays in 2008 but would decrease outlays by $3.3 billion from 2009 to 2012. Alternative 2 would reduce outlays by $600 million in 2008 and $8.2 billion over five years.

A rationale for this option is that it would provide savings amid the growing budgetary pressures posed by mandatory spending while leaving most SMI enrollees unaffected—particularly enrollees with lower income. Under Alternative 1, a large majority of beneficiaries, about 92 percent, would still pay no more than the basic SMI premium in 2012, while less than 1 percent would face the highest premium. More enrollees would be affected under Alternative 2, but about 90 percent would still see no increase in their premium in 2012. Under either alternative, the added cost of the higher premiums would be small compared with enrollees' income. SMI enrollees, including those paying an income-related premium, would still receive a substantial subsidy from taxpayers, including workers with modest earnings.

An argument against this option is that enrollees who faced the higher premiums would effectively see a reduction in their disposable income. Some of those enrollees might drop out of the SMI program as a result. (Few might be expected to do so, however, because enrollment rates for SMI have been historically quite high, even though enrollment for that program is voluntary.)

RELATED OPTION: 570-17

570-17—Mandatory

Increase Premiums Under Medicare's Drug Benefit for Higher-Income Enrollees

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-150	-350	-600	-800	-950	-2,850	-10,150

Currently, most enrollees in Part D of Medicare pay premiums that, on average, are intended to cover about 25 percent of the costs of providing that program's standard drug benefit. Enrollees with low income and few assets can have most or all of their premiums paid by Medicare, but middle-income and higher-income seniors pay the same drug premiums. Middle-income enrollees in Part B of Medicare also pay a premium that covers about 25 percent of that program's average costs, but some higher-income enrollees must pay a larger share starting in 2007. That increase applies to single individuals with an annual income of more than $80,000 and to married couples with a combined income of more than $160,000, and the increase rises in steps until it reaches a maximum amount for those with income above $200,000 (for singles) or $400,000 (for married couples). As modified by the Deficit Reduction Act of 2005, those changes will be phased in over three years and fully implemented in 2009—by which time the premiums paid by those enrollees will cover between 35 percent and 80 percent of average Part B costs.

Under this option, the higher-income enrollees who pay a greater premium for Part B—that is, receive a reduced subsidy from Medicare—would see their subsidy decline to the same degree for Part D. If that option was implemented in 2008 and phased in over three years, federal savings would be $150 million in the first year and $2.9 billion over the 2008–2012 period. That estimate assumes that Medicare's subsidy payments to employers that provide qualified drug coverage would also be reduced for those higher-income retirees and that (as under Part B) the income thresholds would be indexed to general inflation. When fully implemented in 2010, this option would require that affected Part D enrollees pay an increment ranging from about $15 to about $80 per month on top of the average drug premium of about $35 per month for that year.

An argument for this option is that the additional payment represents only a small share of income for the enrollees who would be affected by it. The Congressional Budget Office estimates that less than 5 percent of enrollees would be subject to a higher Part D premium in any given year.

An argument against this option is that some higher-income enrollees would avoid the greater premium by opting out of the program—particularly those who have relatively low drug costs. (CBO assumed that about 1 percent of projected Part D enrollees would ultimately decline to enroll or delay their enrollment as a result of the higher premiums.) Critics maintain that such an outcome could eventually raise premiums for the remaining enrollees, who would have higher average costs. Concerns have also been raised about the administrative costs and burdens of tying enrollees' Medicare premiums to their income. But the incremental costs would be limited under this option because the steps needed to implement it—for example, income verification—are already being taken to carry out Part B provisions for income-related premiums.

RELATED OPTION: 570-16

570-18—Mandatory

Apply a Hold-Harmless Provision to Increases in Medicare's Part D Premium

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	+250	+180	+120	+130	+120	+800	+1,920

Many people enrolled in Medicare Part B (Supplementary Medical Insurance, or SMI) have their premium payments automatically deducted from their Social Security benefit checks. The Medicare Part B premium is set to cover 25 percent of the program's costs. Under current law, the dollar amount of any increase in the Part B premium is limited to the dollar amount of the annual cost-of-living adjustment (COLA) for Social Security benefits. Under that hold-harmless provision, if the calculated increase in the SMI premium is greater than the dollar increase in the Social Security benefit, the premium is reduced by the amount needed to ensure that there is no reduction in the dollar amount of the net Social Security benefit.

This option would apply a similar hold-harmless provision to the increase in premiums for Medicare Part D (the new prescription drug benefit) beginning in 2008. (The option would not affect the initial reduction in the net Social Security benefit that occurs when enrollees first sign up for Part D.) Because Part D premiums will vary among beneficiaries (depending on the particular drug plan they choose), the hold-harmless calculations described here are based on the average premium for Part D plans. In other words, the net Social Security benefit of a beneficiary in an average plan could not fall from year to year. If beneficiaries enrolled in a plan whose increases in premiums were significantly higher than that of the average Part D plan, however, they could see reductions in their net Social Security benefit.

Expanding the current hold-harmless provision to include the Part D premium would increase Medicare spending by $250 million in 2008 and by $800 million over five years. The number of Medicare beneficiaries subject to both the current and proposed hold-harmless provisions would vary considerably over time, primarily because of significant year-to-year fluctuations in the rates of increase in the Part B and Part D premiums.

A rationale for this option is that it would limit the extent to which the rising cost of prescription drugs reduced the amount of income available to the elderly for spending on other goods and services. It would especially protect the net Social Security benefit of beneficiaries with relatively low lifetime wages (and thus low Social Security benefits) because the dollar amount of their COLAs would be relatively small.

An argument against this option is that, by insulating beneficiaries from the full impact of the cost of higher premiums for the drug benefit, the policy might reduce pressures to curb growth in Medicare's drug spending.

570-19—Mandatory

Modify Medicare's Cost-Sharing Requirements

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,600	-2,200	-2,400	-2,600	-2,800	-11,600	-30,800

In Medicare's fee-for-service program—consisting of Part A (Hospital Insurance) and Part B (Supplementary Medical Insurance)—enrollees' cost sharing varies significantly depending on the type of service provided. For example, enrollees who are hospitalized in 2007 must pay a Part A deductible of $992 for each "spell" of illness they incur and are subject to daily copayments for extended hospital stays or skilled nursing care. Meanwhile, the deductible for outpatient services covered under Medicare Part B is $131. Beyond that deductible, enrollees generally pay 20 percent of allowable costs for most Part B services, but cost sharing can be significantly higher for outpatient hospital care. At the same time, certain Medicare services, such as home health visits and laboratory tests, require no cost sharing. As a result of those variations, enrollees are not given consistent incentives to weigh relative costs when choosing among treatment options. Moreover, if Medicare patients incur extremely high medical costs, they can face significant cost sharing, because the program does not cap those expenses.

This option would replace the current complicated mix of cost-sharing provisions with a single combined deductible covering all services in Parts A and B of Medicare, a uniform coinsurance rate of 20 percent for amounts above that deductible (including inpatient expenses), and an annual cap on each enrollee's total cost-sharing liabilities. Specifically, the combined deductible would be $500 in 2008, and the cap on total cost sharing would be $5,000; in later years, those amounts would grow at the same rate as per capita Medicare costs. If this option took effect on January 1, 2008, federal outlays would be reduced by $1.6 billion in that year and by $11.6 billion over five years.

One argument in favor of this option is that it would provide greater protection against catastrophic costs while reducing Medicare's coverage of more-predictable expenses. Capping enrollees' out-of-pocket expenses would especially help people who develop serious illnesses, require extended care, or undergo repeated hospitalizations but lack supplemental (medigap) coverage for their cost sharing. This option would also increase incentives for enrollees to use medical services prudently. Deductibles and coinsurance rates expose enrollees to some of the financial consequences of their health care treatments and are aimed at ensuring that services are used only when their benefits exceed those costs. Although this option's combined deductible would be lower than the Part A deductible, the vast majority of Medicare enrollees are not hospitalized in a given year; thus, most people without supplemental coverage would face the full cost for a larger share of the Part B services that they used. The uniform coinsurance rate across services would also encourage enrollees to compare the costs of different treatment options in a more consistent way. In addition, the resulting reductions in costs for Medicare's Part B program would translate into lower premiums for all enrollees.

An argument against this option is that it would increase cost-sharing liabilities for most Medicare enrollees. Specifically, those liabilities would rise modestly in 2008 for about three-fourths of enrollees (by about $500, on average) and would stay the same for another 15 percent. (For the remaining 10 percent of enrollees, cost-sharing liabilities would fall by an average of about $4,000.) Enrollees who are hospitalized only once in a year would generally face higher costs because of the coinsurance that would apply to that care; however, most Medicare enrollees would be insulated from those direct effects because they have supplemental coverage. (Some enrollees might see the effects in the form of higher premiums for their supplemental policies.) In addition, the option would make enrollees responsible for paying coinsurance for certain services—such as home health care—that are not currently subject to cost sharing. That requirement would increase administrative costs for some types of health care providers and could discourage enrollees from seeking treatment in some cases.

RELATED OPTIONS: 570-20 and 570-21

570-20—Mandatory

Restrict Medigap Coverage of Medicare's Cost Sharing

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,900	-2,900	-3,000	-3,200	-3,400	-14,400	-34,900

Cost-sharing requirements in Medicare's fee-for-service sector can be substantial, so most enrollees obtain supplemental coverage from some source (including the Medicaid program or their former employer). About 25 percent of fee-for-service enrollees buy individual insurance—or medigap—policies that are designed to cover most or all of the cost sharing that Medicare requires. Some studies have found that medigap policyholders use at least 25 percent more services than Medicare enrollees who have no supplemental coverage and at least 10 percent more services than enrollees who have supplemental coverage from a former employer (which tends to reduce, but not eliminate, their cost-sharing liabilities). Because enrollees are liable for only a portion of the costs of those additional services, it is taxpayers (through Medicare) and not medigap insurers or the policyholders themselves who bear most of the resulting costs. Federal costs for Medicare could be reduced if medigap plans were restructured so that policyholders faced some cost sharing for Medicare services but still had a limit on their out-of-pocket costs.

This option would bar medigap policies from paying any of the first $500 of an enrollee's cost-sharing liabilities for calendar year 2008 and would limit coverage to 50 percent of the next $4,500 in Medicare cost sharing. (All further cost sharing would be covered by the medigap policy, so enrollees could not pay more than $2,750 in cost sharing in that year.) If those dollar limits were indexed to growth in average Medicare costs for later years, savings would total $1.9 billion in 2008 and $14.4 billion over five years. Those estimates—which assume that all current and future medigap policies will be required to meet the new standards—reflect a reduction in Medicare costs of about 5 percent for the population of medigap policyholders that would be affected. (Two similar designs for medigap policies were authorized by the Medicare Modernization Act of 2003, but enrollment in them is optional.)

An argument in favor of this option is that most Medicare enrollees who have medigap policies would be better off financially as a result. Because insurers that offer medigap plans must compete for business, they would most likely reduce premiums to reflect the lower costs of providing the new policies. Indeed, most medigap policyholders would have smaller annual expenses under this option because their medigap premiums would decline to a greater extent than their cost-sharing liabilities would increase. (Part of the reason is that premiums for medigap policies are generally somewhat higher than the average cost-sharing liabilities that the policies cover, because of the administrative and other costs that medigap insurers incur. But the primary reason is that most of those liabilities are generated by a minority of policyholders.) Greater exposure to Medicare's cost sharing would also lead some medigap policyholders to forgo treatments that would yield them few or no net health benefits. Indirectly, the decline in Medicare's costs would also cause that program's monthly premiums (which cover 25 percent of costs for Medicare Part B) to fall, so other Medicare enrollees would also benefit.

An argument against this option is that medigap policyholders would face more uncertainty about their out-of-pocket costs. For that reason, some policyholders might object to being barred from purchasing coverage for all of their cost sharing, even if they would be better off financially in most years under this option. (Most medigap policyholders buy optional coverage for the Part B deductible; high-deductible medigap policies have attracted only limited enrollment despite their lower premiums.) Moreover, in any given year, about one-quarter of medigap policyholders would incur higher total costs under this option than they would under the current system, and those with costly chronic conditions might be worse off year after year. Finally, the decline in use of services by medigap policyholders (which would generate the federal savings under this option) might adversely affect their health in some cases.

RELATED OPTIONS: 570-19 and 570-21

570-21—Mandatory

Combine Changes to Medicare's Cost Sharing with Medigap Restrictions

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-3,800	-5,500	-5,800	-6,200	-6,600	-27,900	-69,900

The savings from modifying Medicare's cost-sharing requirements (see Option 570-19) could be increased by limiting medigap coverage at the same time (see Option 570-20). That is, the savings that would result from instituting both changes simultaneously would exceed the sum of the savings derived from implementing each option in isolation. That synergy arises because medigap policyholders would not be insulated from the changes in Medicare's cost-sharing requirements if their medigap plans were also restructured.

Under this option, medigap plans would be prohibited from covering any of the new $500 combined deductible that would be required by Medicare in 2008 (described in Option 570-19) and could cover only 50 percent of the program's remaining cost-sharing requirements. Such a medigap policy would correspond to the one described in Option 570-20, with coverage limited to 50 percent of the next $4,500 in Medicare cost sharing (thus capping enrollees' out-of-pocket expenses at $2,750 in 2008). Under this combined option, the point at which the medigap policy's cap on out-of-pocket costs was reached would also be the point at which the Medicare program's new cap was reached. Between the deductible and the catastrophic cap, policyholders would face a uniform coinsurance rate of 10 percent for all services. If those various dollar limits were indexed to growth in per capita costs for the Medicare program, this option would save $3.8 billion in 2008 and $27.9 billion over five years. Those estimates assume that participation in Medicare's new cost-sharing requirements will be mandatory and that all medigap policies will be required to follow the new standards.

An argument in favor of this option is that it would appreciably strengthen incentives for more prudent use of medical services—both by raising the initial threshold of health care costs that most Medicare beneficiaries faced and by ensuring that enrollees generally paid at least a portion of all subsequent costs (up to the out-of-pocket limit). As a result, the five-year savings from this option would be $1.9 billion more than the sum of savings achieved from Options 570-19 and 570-20.

An argument against this option is that even with the new catastrophic cap—which would protect Medicare enrollees against substantial out-of-pocket expenses—some enrollees would object to any policy that denied them access to full supplemental coverage for their cost sharing. Furthermore, in any given year, a significant number of enrollees would see their combined payments for premiums and cost sharing rise as Medicare's average subsidies were reduced and medigap plans were restructured.

RELATED OPTIONS: 570-19 and 570-20

570-22—Mandatory

Require a Copayment for Home Health Episodes Covered by Medicare

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,600	-2,500	-2,700	-2,900	-3,200	-12,900	-35,500

Medicare's spending for home health care dropped during the late 1990s following enactment of the Balanced Budget Act of 1997, which introduced a prospective payment system for home health services. Since 2000, spending for home health care has been rising, however. And the use of home health services, and the resulting costs to the Medicare program, will grow rapidly over the next 10 years, the Congressional Budget Office projects. One reason for the projected rapid growth is that Medicare beneficiaries are not currently required to pay any of the costs of home health services covered by the program.

This option would charge beneficiaries a copayment amounting to 10 percent of the total cost of each home health episode—a 60-day period of services—covered by Medicare, starting on January 1, 2008. That change would yield net federal savings of $1.6 billion in 2008 and $12.9 billion over five years.

An argument in favor of this option is that it would directly offset a portion of Medicare's home health outlays and encourage beneficiaries to be cost-conscious in their use of those services. The use of services would also decrease, most likely among the approximately 10 percent of beneficiaries with fee-for-service Medicare only (in other words, beneficiaries who are not enrolled in Medicaid or a health maintenance organization and who do not have supplemental insurance, such as medigap or "wraparound" retiree coverage).

An argument against this option is that it would increase the risk of significant out-of-pocket costs for the 10 percent of Medicare enrollees with only fee-for-service coverage and thus could reduce the use of services among that population. Those enrollees tend to have lower income than do beneficiaries with private supplemental insurance. (Among the majority of enrollees who have supplemental insurance, little or no drop in use would be expected, because their supplemental policies would presumably be expanded to cover the home health copayment proposed in this option.) Also, the 25 percent of enrollees with individually purchased medigap policies would probably face higher premiums, and the costs of employer-sponsored medigap policies could also rise (again under the assumption that supplemental policies would cover the proposed home health copayment). Finally, this option would result in increased Medicaid outlays for home health care. (The federal share of higher Medicaid outlays is included in the estimated change in outlays.)

RELATED OPTION: 570-23

570-23—Mandatory

Impose Cost Sharing for the First 20 Days of a Stay in a Skilled Nursing Facility Under Medicare

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,300	-1,900	-2,000	-2,100	-2,300	-9,600	-23,400

For enrollees who have been hospitalized and need continuing skilled nursing care or rehabilitative services on a daily basis, Medicare currently covers up to 100 days of care in a skilled nursing facility (SNF). The average SNF stay covered by Medicare lasts about 20 days, and a substantial share of Medicare's SNF payments are for the first 20 days of such a stay. The first 20 days of SNF care are free to the beneficiary, but the next 80 days require a copayment that is projected to be $124 per day in 2008. That copayment is set at one-eighth of Medicare's deductible for each hospital inpatient "spell," and thus the copayment grows over time along with increases in average daily hospital costs. Total payments to SNFs under Part A of Medicare are projected to average about $396 per day in 2008, so the $124 copayment corresponds to an average coinsurance rate of more than 30 percent. The Congressional Budget Office projects that total Medicare spending for SNF services provided under Part A will rise from $20.4 billion in 2008 to $34.5 billion in 2017.

This option would impose a copayment for each of the first 20 days of care in a skilled nursing facility equal to 5 percent of the inpatient deductible, which would be $51.60 per day in 2008. The maximum additional liability for a beneficiary would thus equal the inpatient deductible (projected by CBO to be $1,032 in 2008) and would rise at the same rate over time. Imposing that copayment would reduce federal outlays by $1.3 billion in 2008 and by $9.6 billion over five years.

The effect of this option on the use of SNF services and beneficiaries' out-of-pocket payments would depend on whether participants had supplemental coverage for their Medicare cost sharing. Most individual medigap policies include full coverage of current SNF copayments, so beneficiaries with such policies would be insulated from the direct impact of the higher copayments but could expect to see the additional costs reflected in their medigap premiums. This option would not affect Medicare beneficiaries who received full Medicaid benefits or those considered qualified Medicare beneficiaries, because their Medicare cost sharing would be paid by Medicaid. The savings shown in this option reflect the additional federal Medicaid spending that would occur as a result. (State Medicaid programs would also pay correspondingly more.)

Overall, 2 percent to 3 percent of all Medicare beneficiaries would incur higher out-of-pocket costs under this option in any given year, CBO estimates. For those beneficiaries, the absence of cost sharing for the first 20 days of SNF care under current law probably encourages additional use of those services. An advantage of imposing a copayment, therefore, would be that those beneficiaries would have to balance the costs and benefits of receiving care in a skilled nursing facility.

One argument against this option is that enrollees who use SNF care would already have been liable for the inpatient deductible as a result of their initial hospital admission. The added copayment could lead some beneficiaries to forgo services that would help avoid further complications from surgery or improve their health in other ways. Some beneficiaries might choose instead to receive similar services as a home health care benefit, which currently has no cost sharing. (The resulting added payments for home health services are reflected in the estimate of net program savings for this option.)

RELATED OPTION: 570-22

570-24—Mandatory

Impose a Deductible and Coinsurance Amounts for Clinical Laboratory Services Under Medicare

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,100	-1,600	-1,700	-1,900	-2,000	-8,300	-21,300

Medicare currently pays 100 percent of approved fees for laboratory services provided to enrollees. Medicare's payment is set by a fee schedule, and providers must accept that fee as full payment for the service. For most other services provided under Medicare's Supplementary Medical Insurance (SMI) program, beneficiaries are subject to both a deductible ($131 in 2007 and updated annually by the increase in the Part B premium) and a coinsurance rate of 20 percent.

This option would impose the SMI program's usual deductible and coinsurance requirements on laboratory services beginning January 1, 2008. The change would yield federal savings of $1.1 billion in 2008 and $8.3 billion over five years.

A rationale for this option is that, besides reducing costs to Medicare, such a change would make cost-sharing requirements under the SMI program more uniform and therefore easier for enrollees to understand. Moreover, although decisions about the appropriateness of tests are generally left to physicians, some enrollees might be less likely to request or undergo laboratory tests of little expected benefit if they had to pay part of the costs themselves.

An argument against this option is that only a small portion of the expected savings would stem from more prudent use of laboratory services; the rest would reflect the transfer to enrollees of costs now borne by Medicare. Moreover, the billing costs of some providers, such as independent laboratories, would be higher under this option because those providers would have to bill both Medicare and enrollees to collect their full fees. (Currently, they have no need to bill enrollees directly for clinical laboratory services.)

570-25—Mandatory

Shorten the Rental Period for Oxygen Equipment Under Medicare

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	-500	-700	-1,000	-1,300	-3,500	-11,000

More than a million Medicare beneficiaries suffer from respiratory illnesses, such as chronic obstructive pulmonary disease, that require them to use supplemental oxygen. Until recently, Medicare made monthly payments to private suppliers for the rental of oxygen equipment indefinitely if it was deemed medically necessary. Beneficiaries were responsible for 20 percent of the costs of such rentals (including fees to rent the equipment and costs to service it).

The Deficit Reduction Act of 2005 replaced that system with a "rent-to-own" system, which became effective January 1, 2006. Under the new system, Medicare will pay for up to 36 months of continuous rental of oxygen equipment, after which the supplier must transfer ownership of the equipment to the beneficiary. Once the equipment has been transferred, the beneficiary no longer has to pay rental fees. After the beneficiary assumes ownership, Medicare will pay to maintain, service, and refill the equipment. As before, beneficiaries continue to be responsible for 20 percent of the cost of those services.

This option would shorten the continuous rental period for oxygen equipment from 36 months to 13 months. As under current law, Medicare would continue to pay 80 percent of the costs for oxygen contents, supplies, and accessories and for maintenance and servicing after ownership of the equipment is transferred from the supplier to the beneficiary. By shortening the rental period for the oxygen equipment, this option would reduce Medicare outlays by $3.5 billion over five years.

Proponents of this option maintain that it would more closely align Medicare's payments for oxygen therapy and the associated equipment with their costs. They argue that Medicare's rental payments under current law far exceed the purchase price of oxygen equipment, resulting in unnecessary Medicare expenditures. Moreover, they contend that limiting the rental period to 13 months would reduce beneficiaries' cost sharing for oxygen equipment.

Opponents of this option point out that oxygen suppliers might reduce the quality and continuity of care for beneficiaries in response to reduced payments from Medicare. In particular, they are concerned that payments after the rental period ends would be insufficient to provide for adequate clinical support, equipment replacement, and 24-hour emergency service. Moreover, after the rental period ends, beneficiaries might face barriers in obtaining new equipment if new technology became available that would improve their quality of life.

570-26—Mandatory

Extend Medicare's Secondary-Payer Status for ESRD from 30 Months to 60 Months

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-40	-150	-240	-280	-310	-1,020	-3,070

Since 1973, patients diagnosed with permanent kidney failure, or end-stage renal disease (ESRD), have been automatically eligible for Medicare regardless of their age. Those individuals typically must undergo regular dialysis or receive a kidney transplant. If they are covered by private group health insurance when they are diagnosed with ESRD, that private coverage remains the primary payer for ESRD-related costs for a 30-month period beginning with the date of Medicare eligibility (which is typically three months following the diagnosis of ESRD). Subsequently, Medicare becomes the primary payer unless normal kidney function returns—for example, following a successful transplant.

This option would extend the period during which Medicare is the secondary payer from 30 months to 60 months. That change would reduce federal spending by $40 million in 2008 and by about $1 billion over five years.

In 2004, approximately 336,000 patients in the United States underwent dialysis. Those patients had an average age of 61 and an average life expectancy of 5.6 years. Roughly 136,000 patients received kidney transplants that year; those patients had an average age of 49 years and average life expectancy of 15.7 years. Medicare was the primary payer for about 80 percent of those dialysis patients and 50 percent of those transplant patients; it was the secondary payer for about 9 percent of the dialysis patients and about 16 percent of the transplant patients. Overall, Medicare spending for ESRD, which today averages more than $50,000 per patient per year, grew from $12 billion in 1998 to over $20 billion in 2004, while spending by private health insurance for ESRD grew from $800 million to $2.3 billion. That growth was driven more by increases in the number of patients with ESRD than by increases in costs per ESRD patient per year.

An argument in favor of this option is that it would bring Medicare's ESRD coverage more closely into line with Medicare's coverage for other chronic diseases. According to that view, individuals who remain covered under their employer's group health plan while they or their family members undergo dialysis or a kidney transplant should continue with that coverage as the primary payer. This option would not affect the majority of ESRD patients, most of whom do not have private coverage when they first experience renal failure, are not eligible for private group coverage beyond the 30-month period (perhaps because they have stopped working), have had a successful transplant, or do not survive beyond the current 30-month period. For beneficiaries affected by the option, the impact would most likely be small because Medicare and private coverage for ESRD are typically similar.

An argument against this option is that it would increase pressure on private health insurers to either raise premiums or drop coverage for ESRD. Also, the option could increase financial difficulties for some individuals whose private group coverage was limited. For example, individuals who reached lifetime dollar caps between their 30th and 60th months following renal failure might have to pay out of pocket for ESRD treatment or seek Medicaid or other sources of coverage.

600

Income Security

Federal income-security programs provide cash or in-kind benefits to individuals. Some, such as Food Stamps, Supplemental Security Income, Temporary Assistance for Needy Families, and the earned income tax credit, are means-tested; others, including unemployment compensation and civil service retirement and disability payments, are not tied to recipients' income or assets.

Retirement and disability programs—including military retirement—constitute the largest portion of federal spending in function 600, accounting for about one-third of the category's mandatory spending. Refundable tax credits make up 17 percent of mandatory spending for 2007, a growth of 61 percent from 2002. Food and nutrition assistance is the next-largest component, making up about 16 percent of mandatory outlays in recent years. Unemployment compensation, which in 2002 and 2003 made up nearly 20 percent of mandatory spending, has fallen back toward the 10 percent mark of the middle to late 1990s. Housing assistance accounts for about 70 percent of discretionary income-security spending.

The Congressional Budget Office estimates that outlays in function 600 will total $364 billion in 2007 and that about $56 billion of that amount will be discretionary spending. Since 2002, growth in spending for the function has averaged about 3 percent annually. That growth is the net effect of legislation that enhanced refundable tax credits (which are recorded as outlays), a decline in unemployment compensation, and slowing growth in the Food Stamp program.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	42.7	44.3	45.2	45.8	47.7	49.5	2.8	3.9
Outlays								
Discretionary	48.0	51.0	52.3	54.3	54.2	55.7	3.1	2.7
Mandatory	264.7	283.6	280.8	291.6	298.2	308.4	3.0	3.4
Total	312.7	334.6	333.1	345.8	352.4	364.1	3.0	3.3

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 13 *Include Employer-Paid Premiums for Income-Replacement Insurance in Employees' Taxable Income*

Revenue Option 20 *Include Social Security Benefits in Calculating the Phaseout of the Earned Income Tax Credit*

Revenue Option 41 *Increase Federal Employees' Contributions to Pension Plans*

600-1—Mandatory

Modify the Assessment Base and Increase the Federal Insurance Premium for Private Pension Plans

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Increase the fixed-rate premium	-168	-173	-179	-189	-194	-903	-1,994
Increase the variable-rate premium	-304	-526	-505	-495	-481	-2,311	-4,351
Increase the variable-rate premium and apply it only to plan sponsors rated below single-A	-214	-372	-357	-349	-340	-1,632	-3,072

The Pension Benefit Guaranty Corporation (PBGC) is a federal agency that insures participants in private employers' defined-benefit pension plans against the loss of specified benefits if their plans are terminated without sufficient assets. Private employers are not required to provide a pension for their workers, but if they do, they must follow rules specified in the Employee Retirement Income Security Act (ERISA) for most major aspects of the plan's operation (including minimum standards for participation, accrual of benefits, vesting, and funding). If a plan is terminated with insufficient assets to pay promised benefits, PBGC takes over the plan's assets and liabilities (up to an annual per-participant limit). It uses the assets of the terminated plans along with insurance premiums from ongoing plans to make monthly annuity payments to qualified retirees and their survivors. At the end of 2006, PBGC reported a deficit of about $18 billion—indicating that its assets were about $18 billion less than the present value of the benefits that it owed to workers and retirees in underfunded plans that were terminated or whose termination the agency viewed as "probable."

PBGC's insurance premium for a single-employer plan consists of three parts: a fixed annual payment ($31 in 2007) for each participant (worker or retiree) in the plan; for an underfunded plan, a variable payment equal to $9 for each $1,000 by which the plan is underfunded; and for a plan terminated after January 2006, a $1,250 payment for each participant in each of the first three years following the sponsor's emergence from bankruptcy. In 2006, offsetting receipts (a credit against direct spending) from the fixed portion of the premium totaled about $984 million; and from the variable portion, about $595 million.

Under one alternative, this option would increase collections from the fixed-rate premium by 15 percent. The increase could occur by either increasing the current charge from $31 per participant to $35 or by changing the assessment base to some measure of insured benefits and setting the premium to a level yielding 15 percent more collections. This component of the option would increase offsetting receipts by more than $160 million in 2008 and by about $900 million over five years.

Under a second alternative, which could be pursued singly or in combination with the first, this option would increase the variable-rate premium by one-third, to $12 per $1,000 of underfunding. This change would increase offsetting receipts by about $300 million in 2008 and by $2.3 billion over five years. Under a third alternative, which also could be pursued on its own or along with the first, this option would apply the higher variable-rate premium only to sponsors with a credit rating below single-A. This alternative would increase offsetting receipts by more than $200 million in 2008 and by $1.6 billion over five years.

A principal advantage of increasing premiums is that doing so could improve PBGC's long-term financial condition. Raising premiums for riskier plans would also align premiums more closely with the risk they pose to PBGC. Currently, premiums increase only with underfunding, even though other factors, such as the financial condition of the sponsors and the share of plans' assets allocated to risky securities, also increase the risk to PBGC. By raising the cost of maintaining underfunded or riskier plans, this option would provide an added incentive to employers to more fully fund their plans.

Moreover, the current per-participant charge may constitute a disadvantage for new firms with a disproportionate share of employees who have accumulated few pension benefits. An advantage to changing the assessment base for the fixed-rate premium rather than increasing the per-participant charge is that doing so would more directly relate the fixed-rate premium to the level of insured benefits.

A disadvantage of this option is that the increases in premiums would not necessarily be well targeted to plans that PBGC eventually took over because charges would still be relying on the amount of underfunding in a plan and its bond rating, which are not perfectly related to the probability that the plan will be terminated. In addition, raising the insurance premiums for underfunded plans may not be enough to improve PBGC's long-term financial condition. Finally, for financially weak employers, higher premiums could increase the risk that they would terminate their plans.

RELATED CBO PUBLICATIONS: *The Risk Exposure of the Pension Benefit Guaranty Corporation,* September 2005; *A Guide to Understanding the Pension Benefit Guaranty Corporation,* September 2005; *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees,* August 2004; and *Controlling Losses of the Pension Benefit Guaranty Corporation,* January 1993

600-2—Mandatory

Modify the Formula Used to Set Federal Pensions

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Outlays							
Alternative 1: Use five-year average salary	-42	-131	-225	-327	-435	-1,160	-4,959
Alternative 2: Use four-year average salary	-20	-63	-111	-164	-220	-578	-2,497

The government's major retirement plans for civilian employees—the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS)—provide initial benefits (those provided before cost-of-living adjustments are applied) that are based on the average of an employee's highest earnings over three consecutive years. In 2008, outlays for pension benefits under the two programs are projected to total $62.8 billion.

This option would use a five-year average instead of a three-year average to compute benefits for workers who retire under CSRS and FERS after September 30, 2007. As a result, initial pensions would be about 3 percent smaller for most new civilian retirees, saving the federal government $42 million in 2008 and a total of $1.2 billion over five years. The average new CSRS retiree would receive about $1,250 less in 2008 and $6,530 less over five years than under current law. By comparison, the average new FERS retiree would receive $420 less in 2006 and $2,190 less over five years.

Under an alternative approach, a four-year average would be used for CSRS and FERS. Such action would yield savings of $20 million in 2008 and $580 million over five years. The average new CSRS retiree would receive $600 less in 2008 and $3,140 less over five years while the average new FERS retiree would receive $200 less in 2008 and $1,060 less over five years.

One rationale for using a longer average is that it would better align federal practices with those in the private sector, which commonly uses five-year averages to calculate a worker's base pension. The change in formula also would encourage some federal employees to work longer in order to boost their pensions. That incentive could help the government retain experienced personnel.

A rationale against this option is that cutting pension benefits would reduce the attractiveness of the government's civilian compensation package. In addition, this option would reduce benefits more under CSRS than under FERS because CSRS provides a bigger defined-benefit pension than FERS. Federal employees under FERS also participate in Social Security and receive government contributions to the 401(k)–like Thrift Savings Plan, while those employees under CSRS do not.

RELATED OPTIONS: 600-3, 600-4, and Revenue Option 41

RELATED CBO PUBLICATIONS: *Measuring Differences Between Federal and Private Pay*, November 2002; *The President's Proposal to Accrue Retirement Costs for Federal Employees*, June 2002; *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998; *Comparing Federal Salaries with Those in the Private Sector*, July 1997; and *Testimony on Financing Retirement for Federal Civilian Employees*, June 28, 1995

600-3—Mandatory

Base Cost-of-Living Adjustments for Federal and Military Pensions and Veterans' Benefits on an Alternative Measure of Inflation

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-332	-780	-1,241	-1,753	-2,149	-6,255	-24,671

Federal pension payments to 4.2 million retired federal workers (both civilian and military) and their survivors are projected to be $104 billion in 2007. For the same year, pension payments to about 516,000 veterans and their survivors are projected to be $3.2 billion, and compensation to 3 million disabled veterans and their survivors is projected to be $30 billion. In addition, veterans' readjustment benefits (including education and vocational rehabilitation benefits) for about 513,000 veterans and their survivors are projected to be $3 billion. All those benefits are indexed to the increase in the consumer price index for urban wage earners and clerical workers (CPI-W), but the size of the adjustment varies among programs, as does the age at which benefits are payable.

- Pensions paid to former federal workers under the Civil Service Retirement System (CSRS) are subject to annual cost-of-living adjustments (COLAs) that provide complete protection against increases in the CPI-W. Pensions paid under the newer Federal Employees Retirement System (FERS) are fully protected only when that increase is less than 2 percent a year. If the percentage increase in the CPI-W is between 2 percent and 3 percent, FERS annuitants receive a COLA of 2 percent. If the CPI-W increase exceeds 3 percent, their COLA is the percentage increase in the CPI-W minus 1 percentage point. In addition, FERS annuitants receive COLAs only at ages 62 and above—except for those retiring on disability. Both CSRS and FERS participants can generally start receiving pension benefits at age 60 with 20 years of service or at age 62 with five years of service. However, participants with 30 years of service can retire at earlier ages.

- Pensions paid to military retirees hired before August 1, 1986, qualify for full COLAs. Military personnel who enter service after that date face a choice: They can elect to stay under the old system and receive a full COLA, or they can opt to receive a $30,000 bonus at their 15th year of service and receive reduced annual COLAs that equal the percentage increase in the CPI-W less 1 percentage point. Under the latter arrangement, when those retirees turn 62, they receive a one-time adjustment or "catch-up" that restores their annuity to what it would have been had the full COLA been paid. After age 62, they continue to receive the reduced COLA. However, to date, most military personnel have opted to forgo the bonus at 15 years of service and thus remain eligible for the full COLA. Military personnel who retire from the active-duty force are eligible to receive their pension benefits after completing 20 years of service without any accompanying age requirements. (Reservists are not eligible for retirement annuities until they reach 60.) Personnel with fewer than 20 years of service generally are not eligible for any benefits unless they qualify for retirement on disability.

- Veterans' benefit programs—including disability compensation and death benefits for survivors, vocational rehabilitation, pensions, and education benefits for veterans and their survivors—all receive full COLAs. Disability benefits are payable to veterans who have certified disabilities, with the amount of the payment depending upon the severity of the disability. Veterans also are eligible for means-tested pension benefits.

This option would base all cost-of-living adjustments for federal civilian and military retirees and veterans' benefits on the increase in the chained CPI, an alternative measure of inflation developed by the Bureau of Labor Statistics. The Congressional Budget Office estimates that the chained CPI is likely to grow 0.3 percentage points more slowly per year than the standard CPI.

Under this option, annual COLAs would equal the increase in the chained CPI for CSRS annuitants, pre-1986 military retirees, and veterans. Comparable adjustments would be made for FERS annuitants, who would

receive the full COLA when the increase in the chained CPI was less than 2 percent a year; a COLA of 2 percent when the increase in the chained CPI was between 2 percent and 3 percent; and a COLA 1 percentage point below that increase when it exceeded 3 percent. Military retirees under the new system would receive a reduced COLA equal to the percentage growth in the chained CPI minus 1 percent.

Those changes would decrease mandatory outlays by $332 million in 2008 and by $6.3 billion over the 2008–2012 period. On average, a CSRS retirement annuitant would receive about $1,230 less over five years than under current law, and a FERS retirement annuitant would receive about $300 less. The average military retiree would receive roughly $1,250 less over five years relative to current law, whereas veterans' disability compensation would fall by about $410 and veterans' pensions by about $390. (Using the chained CPI for all federal benefit programs that are indexed for inflation would reduce outlays by $35.4 billion over the 2008–2012 period and by nearly $140 billion through 2017.)

A rationale for limiting COLAs is that many analysts believe the CPI-W overstates increases in the cost of living and that using the alternative measure would reduce federal outlays while ensuring that benefits did not fall any lower in real terms than they were when the recipients became eligible for the programs. (For more details, see the discussion in Option 650-1.) In addition, federal pension plans offer greater inflation protection than most private pension plans do, and COLAs are becoming increasingly scarce in the private sector. According to a 2001 survey, fewer than 15 percent of private-sector plans gave annuitants formal annual COLAs; another 25 percent made cost-of-living adjustments on an ad hoc basis. More than 60 percent of plans had made no adjustments during the previous 10 years. Moreover, even with reduced COLAs, many federal and military annuitants would still fare better than other retirees because they are covered by the comprehensive Federal Employees Health Benefits program or have access to military treatment facilities, and Tricare, the military's health plan. Veterans also have access to federal facilities.

Various arguments against limiting COLAs also could be made. Using the alternative measure of inflation could be more difficult to implement because the chained CPI is subject to revisions. In addition, that measure might understate changes in the cost of living for retirees, whose expenditure patterns differ from those of the general population. In that case, limiting COLAs could allow the benefits received by both current and future retirees to decline over time in real terms. CSRS annuitants would be particularly affected because they are most dependent on their pensions (and may have stayed with CSRS on the basis of the understanding that they would enjoy the current COLA protection against inflation.) Moreover, because current and prospective employees take into account the relatively large retirement benefits offered by the government when comparing alternative wage and benefit packages, reducing federal retirement benefits could affect the government's ability to recruit and retain a highly qualified workforce. Finally, because military personnel can retire at earlier ages and receive an immediate pension after just 20 years of service, lower COLAs for them would have bigger effects over longer periods. And, reducing veterans' education benefits might reduce the number of veterans who could afford to continue their education.

RELATED OPTIONS: 600-2, 600-4, 650-1, and Revenue Options 6 and 41

RELATED CBO PUBLICATIONS: *Comparing the Pay of Federal and Nonfederal Law Enforcement Officers*, August 2005; *Measuring Differences Between Federal and Private Pay*, November 2002; *The President's Proposal to Accrue Retirement Costs for Federal Employees*, June 2002; *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998; *Comparing Federal Salaries with Those in the Private Sector*, July 1997; and *Testimony on Financing Retirement for Federal Civilian Employees*, June 28, 1995

600-4—Discretionary

Restructure the Government's Matching Contributions to the Thrift Savings Plan

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-359	-383	-409	-436	-464	-2,051	-4,855
Outlays	-359	-383	-409	-436	-464	-2,051	-4,855

Today, most federal workers covered by the Federal Employees Retirement System (FERS) can direct up to $15,500 of their salary to the Thrift Savings Plan (TSP), which is similar to a 401(k) plan. (Employees who are 50 and older are able to make an additional "catchup" contribution of up to $5,000.) The Internal Revenue Service sets the contribution limit and adjusts it annually. Previously, the limits capped workers' contributions at 15 percent of their salary, but that percentage cap was removed in January 2006. Under FERS, federal agencies automatically contribute an amount equal to 1 percent of an employee's salary to the TSP; agencies also match the first 3 percent of workers' voluntary contributions to the TSP dollar for dollar and match the next 2 percent of contributions at 50 cents on the dollar. Thus, although those employees can save higher shares of their earnings in the TSP, they receive the maximum government match by contributing just 5 percent. (Federal workers covered by the Civil Service Retirement System, the older federal plan, can contribute up to $15,500 of their salary to the TSP, but they receive no government match.)

This option would restructure the TSP contribution schedule so that the government made the full 5 percent match only when employees contribute 10 percent of their salary. Specifically, federal agencies would continue to automatically contribute an amount equal to 1 percent of employees' earnings and match the first 2 percent of voluntary contributions dollar for dollar (a maximum match of 2 percent). Contributions ranging from 3 percent to 10 percent would be matched at 25 cents per dollar (a maximum match of another 2 percent). That restructuring would save $359 million in 2008 and $2.1 billion over the 2008–2012 period.

A justification for changing the government's matching schedule is that it would bring federal practices more in line with those of the private sector, which usually provides lower matches and no automatic contributions to defined-contribution plans. For example, according to the Bureau of Labor Statistics, the most prevalent practice among medium-sized and large private firms is to match employees' contributions of up to 6 percent of pay at 50 cents on the dollar. This option would also give some FERS employees, especially those now contributing 5 percent of their earnings, incentive to set aside more in the TSP and thus have more savings available when they retire. Furthermore, restructuring matching contributions might reduce the disparity that currently exists between the government's two major retirement systems. In most cases, the benefits that an employee receives under FERS—which include Social Security and the TSP—cost the government more than the benefits that the same employee would receive under the Civil Service Retirement System.

There are several rationales against implementing the option. First, a lower government match on smaller contributions could reduce some workers' incentive to participate in the TSP or to continue contributing at their current rates. Second, the government might be faulted for saving money at the expense of those employees who are least likely to contribute a higher percentage of their earnings to the TSP—young workers and others with relatively low pay. Third, changing the TSP could be considered unfair because one factor that affected many people's decision to accept employment with the government or to switch from the Civil Service Retirement System to FERS was their assumption that TSP benefits would remain the same.

RELATED OPTIONS: 600-2, 600-3, and Revenue Option 41

RELATED CBO PUBLICATIONS: *Measuring Differences Between Federal and Private Pay*, November 2002; *Comparing Federal Employee Benefits with Those in the Private Sector*, August 1998; *Comparing Federal Salaries with Those in the Private Sector*, July 1997; and *Testimony on Financing Retirement for Federal Civilian Employees*, June 28, 1995

600-5—Mandatory

End the Trade Adjustment Assistance Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-960	-970	-1,000	-1,010	-1,030	-4,980	-10,500
Outlays	-510	-950	-1,000	-1,010	-1,030	-4,500	-10,010

The Trade Adjustment Assistance (TAA) program offers income-replacement benefits, training, and related services to workers who lose a job as a result of competition from imports or a shift of production to another country. To obtain assistance, affected workers must first petition the Secretary of Labor for certification and then meet other eligibility requirements. Cash benefits are available to certified workers who receive training, but only after they have exhausted their unemployment insurance benefits. Legislation enacted in 2002 expanded eligibility for the program and provided displaced workers with a refundable tax credit of 65 percent of their health insurance premiums.

Ending the TAA program by issuing no new certifications in 2008 and thereafter would reduce federal outlays by about $500 million in 2008 and by $4.5 billion through 2012. Affected workers could still apply for benefits under the Workforce Investment Act of 1998, which authorizes a broad range of employment and training services for displaced workers regardless of the cause of their job loss. (This option would also increase revenues because it would eliminate the refundable tax credit for a portion of their health insurance costs that TAA beneficiaries qualify for. Revenues would be about $20 million higher in 2008, the Joint Committee on Taxation estimates, and $150 million higher through 2012.)

A rationale for this option is that such a change would help ensure that federal programs offered more-uniform assistance to workers who were permanently displaced as a result of changing economic conditions. Because the Workforce Investment Act provides cash benefits only under limited circumstances and does not provide a subsidy for health insurance premiums, workers who lose a job because of foreign competition or as a result of a shift in production to another country are generally treated more generously than are workers who are displaced for other reasons.

An argument against this option is that eliminating TAA benefits could cause economic problems for some workers who have been unemployed for a long time and who otherwise would have received such benefits. Another way of securing more-equal treatment for displaced workers, regardless of the reason for their job loss, would be to expand benefits for displaced workers who are not currently eligible for the TAA program.

600-6—Discretionary

Increase Payments by Tenants in Federally Assisted Housing

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-494	-1,014	-1,560	-2,135	-2,739	-7,942	-22,753
Outlays	-370	-884	-1,424	-1,992	-2,588	-7,258	-21,975

Most low-income tenants who receive federal rental assistance are aided through the Housing Choice Voucher program, the low-rent Public Housing program, or project-based assistance programs (which designate privately owned government-subsidized units for low-income tenants). Administered by the Department of Housing and Urban Development (HUD), those programs usually require that tenants pay 30 percent of their monthly gross household income (after certain adjustments) for rent; the federal government subsidizes the difference between that amount and the maximum allowable rent. In 2006, the Congressional Budget Office estimates, the average federal expenditure for all of HUD's rental housing programs combined was roughly $7,070 per assisted household. That amount includes both housing subsidies and fees paid to agencies that administer the programs.

This option would increase tenants' rent contributions over a five-year period, raising them from 30 percent of adjusted gross income to 35 percent. Provided that federal appropriations are lowered to offset those higher contributions by tenants, savings in outlays would total $370 million in 2008 and $7.3 billion over five years, including $3.3 billion for the Housing Choice Voucher program, $1.6 billion for the Public Housing program, and $2.4 billion for project-based assistance programs.

An argument for this option is that its effects on tenants could be cushioned by encouraging states to make up some or all of the decrease in federal support. States currently contribute no funds to federal rental assistance programs, even though such programs generate substantial local benefits, including improvements in the quality of the housing stock and in the general welfare of assisted tenants.

An argument against the option is that some states might not increase their spending to compensate for the reduction in federal assistance. As a result, housing costs could rise for current recipients of aid. For those with the very lowest income, even a modest increase in rent could be difficult to manage. Moreover, by increasing the percentage of their income that tenants are required to pay toward rent, the option would reduce their incentive to work.

RELATED OPTION: 600-7

600-7—Discretionary

Reduce Rent Subsidies for Certain One-Person Households

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-34	-66	-98	-129	-160	-487	-1,716
Outlays	-13	-47	-79	-111	-141	-392	-1,535

Recipients of federal housing assistance typically live either in subsidized-housing projects or in rental units of their own choosing found on the open market. Financial support for the second type of assistance usually comes in the form of vouchers—specifically, from the Housing Choice Voucher program. Administered by the Department of Housing and Urban Development, that program pays the difference between a tenant's contribution (usually 30 percent of his or her monthly adjusted gross income) and rent (which is determined by local rent levels).

Both the local payment standard and the federal subsidy vary according to the type of unit in which a given tenant lives. Generally, an individual in a one-person household may choose an apartment with up to one bedroom. Recipients in larger households may rent larger units.

This option would link the rent subsidy for new applicants from one-person households to the cost of an efficiency apartment rather than a one-bedroom unit. (The change would also apply to any single person receiving assistance who moved to another subsidized unit.) Provided that federal appropriations are adjusted accordingly, the option would save $13 million in outlays next year and $392 million through 2012.

A rationale for this option is that an efficiency unit should provide adequate space for someone who lives alone. A potential drawback is that renters in some areas might have difficulty finding an efficiency apartment and, under the new rule, might have to spend a larger percentage of their income for a one-bedroom unit.

RELATED OPTION: 600-6

600-8—Mandatory

Eliminate Small Food Stamp Benefits

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-35	-70	-70	-70	-70	-315	-680

Under the Food Stamp program, applicants must meet eligibility requirements to receive a monthly benefit. In general, among other conditions, household income must be at or below 130 percent of the federal poverty line, and countable assets must be less than $2,000.

Once eligibility for the program has been determined, the amount of the benefit is calculated. A household is expected to contribute 30 percent of its net income (gross income minus deductions for certain expenses) toward food expenditures. The Department of Agriculture has calculated the monthly cost of a so-called Thrifty Food Plan for households of various sizes. The Food Stamp benefit equals the amount by which the monthly cost of the Thrifty Food Plan exceeds 30 percent of a given household's net monthly income. A minimum benefit has been set for one- and two-person households: If the calculated benefit is less than $10, the Food Stamp benefit is $10.

This option would eliminate Food Stamp benefits for one- and two-person households whose calculated benefit was less than $10 a month. The change would reduce outlays by $35 million in 2008 and by $315 million over five years.

A rationale for this option is that it would reserve Food Stamp benefits for recipients who had the greatest calculated need. An argument against the option is that eliminating Food Stamps for households that currently are eligible for benefits of less than $10 a month might discourage those households from applying for the program if their financial situation worsened. If the option did discourage such applications, it would lessen the extent to which the program achieved its goal of aiding low-income households.

600-9—Mandatory

Target the Subsidy for Certain Meals in Child Nutrition Programs

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-90	-585	-615	-645	-675	-2,610	-6,385
Outlays	-75	-520	-610	-640	-670	-2,515	-6,270

The School Lunch Program and the School Breakfast Program provide funds that enable participating schools to offer subsidized meals to students. In general, participating schools offer free meals to students whose household income is at or below 130 percent of the federal poverty line, reduced-price meals to students whose household income is above 130 percent but at or below 185 percent of the federal poverty line, and full-price meals to students whose household income is above 185 percent of the poverty line.

The subsidy rate per meal does not vary with the cost that a given school incurs as a result of providing the lunch or breakfast—it depends solely on the household income of the student who receives the meal. For the 2006–2007 school year, federal cash subsidies total $2.40 per free lunch and $1.31 per free breakfast served; $2.00 per reduced-price lunch and $1.01 per reduced-price breakfast served; and $0.23 per full-price lunch and $0.24 per full-price breakfast served. (Schools in Alaska and Hawaii and schools that have large numbers of students who participate in the free- and reduced-price-meal programs receive an additional subsidy.) Although each school sets the prices it charges students for reduced- and full-price meals, the reduced-price lunch may not cost more than $0.40, and the reduced-price breakfast may not cost more than $0.30.

This option, which would yield net reductions in outlays of $75 million in 2008 and more than $2.5 billion over five years, would eliminate the breakfast and lunch subsidy for full-price meals for students whose household income is above 350 percent of the poverty line, beginning in July 2008. At the same time, it would increase the subsidy for a reduced-price meal (both breakfast and lunch) by $0.20.

A rationale for this option is that there is no clear justification for subsidizing meals for students who are not from low-income households. An argument against the option is that if a participating school has been using funds from the full-price subsidy to offset the overall costs of administering its breakfast and lunch programs, it might decide to raise meal prices for students from higher-income households, or it might drop out of the program altogether. The latter outcome would mean that students who were eligible for free or reduced-price meals would no longer receive them.

600-10—Mandatory

Reduce the Exclusion for Unearned Income Under the Supplemental Security Income Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-110	-150	-150	-170	-140	-720	-1,540

The federal Supplemental Security Income (SSI) program provides monthly cash payments—based on uniform, nationwide eligibility rules—to low-income elderly and disabled people. In addition, many states provide supplemental payments. Because SSI is a means-tested program, recipients' non-SSI income can reduce their SSI benefits, subject to certain exclusions. For unearned income (which is mostly Social Security benefits), $20 a month is excluded from the benefit calculation; above that amount, SSI benefits are reduced dollar for dollar. To encourage SSI recipients to work, the program allows a larger exclusion for earned income.

This option would lower the exclusion for unearned income from $20 a month to $15, reducing outlays by $110 million in 2008 and by $720 million over five years.

A rationale for this option is that a program designed to ensure a minimum standard of living for its recipients does not need to provide a higher standard for those people who happen to have unearned income (generally, Social Security benefits). An argument against the option is that reducing the monthly exclusion by $5 would decrease by as much as $60 the income of the roughly 2.8 million low-income people (approximately 40 percent of all federal SSI recipients) who otherwise would benefit in 2008 to a greater extent from the exclusion.

RELATED OPTIONS: 600-11 and 600-12

600-11—Mandatory

Create a Sliding Scale for Children's Supplemental Security Income Benefits Based on the Number of Recipients in a Family

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	-80	-170	-190	-165	-605	-1,615

The federal Supplemental Security Income (SSI) program makes cash payments to low-income elderly and disabled people on the basis of uniform, nationwide eligibility rules. In addition, many states provide supplemental payments to program recipients. In 2007, children will receive approximately $7 billion, or about one-fifth of total benefits.

Unlike other means-tested benefits, SSI payments for each additional child do not decline as the number of SSI recipients in a family increases. For instance, in 2007, a family that includes one child who qualifies for SSI benefits can expect to receive up to $623 a month if the family's income (excluding SSI benefits) is under the cap for the maximum benefit. If the family includes other eligible children, it can receive another $623 a month for each additional child. (A child's benefit is based on the presence of a severe disability and on the family's income and resources. Neither the type of disability nor participation by other family members in the SSI program is considered.)

This option would create a sliding scale for SSI disability benefits so that a family would get incrementally fewer benefits per child as the number of children in the family who qualified for SSI increased. If the option was implemented in 2009 (to allow the Social Security Administration, which administers the SSI program, to gather data on multiple SSI recipients in individual families), outlays would drop by $80 million in 2009 and by $605 million between 2009 and 2012.

Recommended by the National Commission on Childhood Disability in 1995, the sliding scale that this option presents would keep the maximum benefit for one child at the level currently allowed by law. However, benefits for each additional child in the same family would be correspondingly reduced. If the sliding scale was applied in 2007, the first child in a family who qualified for the maximum benefit would continue to receive $623 a month. But the second child would get $389, and the third would receive $332. Benefits would continue to decrease for additional children in the same family. As with current SSI benefits, the payments would be adjusted each year to reflect changes in the consumer price index.

Proponents of a sliding scale argue that the resulting reductions in benefits would reflect economies of scale that generally affect the cost of living for families who have more than one child. Furthermore, the high medical costs that disabled children often incur, which would not be subject to economies of scale, would continue to be covered because SSI participants are generally eligible for Medicaid.

An argument against this option is that children with disabilities sometimes have unique needs (such as housing modifications and specialized equipment) that may not be covered by Medicaid. If SSI benefits were reduced, some families might be unable to meet those needs.

RELATED OPTIONS: 600-10 and 600-12

600-12—Mandatory

Remove the Ceiling on the Collection of Overpayments from the Supplemental Security Income Program

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-70	-100	-105	-115	-100	-490	-1,105

The federal Supplemental Security Income (SSI) program makes monthly cash payments to low-income elderly and disabled people. The Social Security Administration (SSA), which administers the program, sometimes pays recipients more than it later determines they should have received. According to a report issued by the General Accounting Office (now the Government Accountability Office), the complexity of the rules that govern the SSI program is a primary reason for the overpayments.[1]

After discovering an overpayment, the SSA may reduce the recipient's subsequent monthly benefit to recover the excess amount. Under current rules, however, the maximum that the SSA may deduct from a recipient's monthly payment is the lesser of two amounts: the recipient's entire monthly SSI benefit or 10 percent of the recipient's total monthly income (minus certain exclusions). Thus, the SSA may deduct no more than 10 percent of the monthly SSI benefit of a recipient who has no other source of income. Moreover, the Commissioner of Social Security may lower the rate of recovery or waive collection of an overpayment altogether if it is determined that doing so would support the purposes of the SSI program.

This option would remove the ceiling on the amount of overpayments that the SSA could recover from monthly SSI payments but retain the commissioner's discretionary authority to reduce or waive the required amount. Removing the 10 percent ceiling would increase the amount collected from overpayments—and thereby reduce net outlays for benefits—by $70 million in 2008 and by $490 million over the 2008–2012 period. (Removing the ceiling would increase administrative costs by about $35 million to $45 million each year; however, those costs are subject to the appropriation process and are not included in the amounts shown in the table.)

An argument in support of this option is that removing the ceiling would improve the federal government's ability to recover money paid to recipients erroneously. Moreover, retention of the commissioner's discretionary authority would lessen the chances that such recoveries would result in undue hardship for SSI recipients.

An argument against the option is that SSI recipients generally have low income and few, if any, financial assets. For recipients who have no other income, even a 10 percent reduction in their SSI payments might be difficult to manage. The current ceiling allows affected recipients to pay the amount they owe in small increments, which limits the reduction they must make in their current spending.

1. General Accounting Office, *Supplemental Security Income: Progress Made in Detecting and Recovering Overpayments, but Management Attention Should Continue,* GAO-02-849 (September 16, 2002), p. 19.

RELATED OPTIONS: 600-10 and 600-11

600-13—Mandatory

Increase Funding for Child Care

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	+163	+245	+327	+408	+490	+1,634	+5,309
Outlays	+123	+221	+305	+386	+468	+1,503	+5,068

The Child Care and Development Block Grant, which provides money to states to subsidize the child care expenses of low-income families, is funded through a combination of discretionary appropriations and a capped entitlement. Created in 1990, the program was subsequently modified and reauthorized through 2002 as part of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996. Between 2002 and 2005, the capped entitlement—which included annual increases through 2002 under the 1996 law—was held at its 2002 level of $2.7 billion per year and was not adjusted for inflation. That part of the block grant was recently increased, as part of the Deficit Reduction Act of 2005, to $2.9 billion per year through 2010.

This option would increase the 2008 authorization for the entitlement portion of the block grant to adjust for inflation since 2006 and would index that amount thereafter. That change would boost federal spending by $123 million in 2008 and by $1.5 billion through 2012.

A rationale for indexing the entitlement portion of the block grant is that it would maintain low-income families' access to subsidized child care. That access, in turn, would increase the incentive to work for some low-income parents, making it easier for them not only to enter the job market but also to stay employed. Increased participation in paid child care might also improve children's well-being, potentially decreasing their behavioral problems while increasing their social skills and their readiness to enter school.

An argument against this option is that many low-income parents have access to informal, or unpaid, care (from a relative, for example). In those cases, increases in child care subsidies might simply result in those parents' shifting from unpaid to paid care. Furthermore, there is little evidence about the effects on children of informal (as opposed to paid) care.

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Social Security

Social Security, the federal government's largest program, consists of two parts: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI). As of December 2006, OASI was paying benefits to 41 million people; another 9 million were receiving DI benefits. In 2006, benefits totaled $454 billion and $91 billion, respectively, for the two programs. Discretionary outlays, mainly for administrative costs, totaled about $5 billion last year.

Spending on OASI benefits has grown at an average annual rate of about 4 percent over the past few years (with annual cost-of-living adjustments accounting for roughly two-thirds of the increase); payments go mostly to retired workers and their spouses and to elderly widows. Although some younger people—chiefly the children of deceased workers—qualify for OASI, 95 percent of the payments go to people age 62 or older. Recipients of disability insurance are mainly in their 50s and early 60s. DI outlays have more than doubled over the past decade, fueled partly by the aging of the baby-boom generation, a phenomenon that will continue to cause increased spending over the next decade. Under current law, OASI outlays also will rise rapidly as people born after World War II begin to qualify for Social Security benefits.

Under current law, the Social Security trust funds will be exhausted in 2046, according to the Congressional Budget Office's most recent projections (see *Updated Long-Term Projections for Social Security,* June 2006). If the funds were exhausted, the Social Security Administration would not have the legal authority to provide the full benefits that are scheduled to be paid to future beneficiaries. In other publications, CBO has presented scenarios for scheduled and payable benefits, but for the sake of simplicity, this report discusses only scheduled outlays.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	3.5	3.8	4.1	4.4	4.6	4.7	7.2	1.3
Outlays								
Discretionary	3.9	4.2	4.0	4.6	4.6	4.7	4.4	1.9
Mandatory	452.1	470.5	491.5	518.7	543.9	580.8	4.7	6.8
Total	456.0	474.7	495.5	523.3	548.5	585.6	4.7	6.7

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (PL. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

IN ADDITION TO THE OPTIONS IN THIS SECTION, SEE THE FOLLOWING:

Revenue Option 18 *Tax Social Security and Railroad Retirement Benefits Like Defined-Benefit Pensions*

Revenue Option 39 *Increase the Maximum Taxable Earnings for the Social Security Payroll Tax*

650-1—Mandatory

Base Social Security Cost-of-Living Adjustments on an Alternative Measure of Inflation

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,300	-3,200	-5,100	-7,200	-9,300	-26,100	-106,000

Each year, the Social Security Administration adjusts recipients' monthly Social Security benefits as specified by law. The 3.3 percent cost-of-living adjustment (COLA) that went into effect in January 2007 was based on the increase in the consumer price index for urban wage earners and clerical workers (CPI-W) between the third quarters of 2005 and 2006. (That index is calculated by the Bureau of Labor Statistics, or BLS.) The Social Security Administration starts raising the basic level of benefits to correspond to the percentage increase in the CPI-W when workers become eligible for benefits—for retired workers, at age 62.

The consumer price index, however, may overstate inflation because it does not fully account for changes in patterns of spending. This option would slow the growth of Social Security outlays by setting the COLA equal to an alternative measure of inflation that BLS also calculates—the chained CPI—beginning in 2008. In the Congressional Budget Office's estimation, the chained CPI is likely to grow 0.3 percentage points more slowly than the standard CPI. Setting the COLA equal to the growth in that alternative measure would reduce federal outlays by $1.3 billion in 2008 and by $26 billion over five years. (Using the same alternative measure for all benefit programs that are indexed for inflation would reduce federal spending by $34.5 billion over the five-year period and by nearly $140 billion through 2017.) By 2050, the use of the chained CPI in calculating the COLA would have reduced Social Security outlays by 4 percent—or, measured as a percentage of gross domestic product, from 6.5 percent to 6.2 percent. Most of that reduction (in percentage terms) would be achieved by 2030.

Several other options that would reduce Social Security outlays—such as raising the normal retirement age (Option 650-5) and constraining the increase in initial benefits (Option 650-6)—would affect only future beneficiaries. By contrast, this option would reduce benefits received by current beneficiaries so that the present generation and future generations would share more evenly in the reductions. Also, unlike other approaches that would permanently reduce the rate of growth of Social Security outlays, this option would reduce that growth rate only temporarily. Thereafter, spending would be lower, but it would grow at the same rate as average wages—as it would under current law.

A rationale for this option is that if the CPI-W overstates increases in the cost of living, as many analysts assert, then decreasing the COLA by a corresponding amount would reduce federal outlays but ensure that benefits did not fall any lower in real (inflation-adjusted) terms than they were when recipients became eligible for the program. Devising a "true" cost-of-living index is problematic, however, and collecting and compiling data for such an index is difficult because the types of goods that people buy change constantly. BLS attempts to account for the introduction of new products and for changes in the quality of existing products, but those efforts are necessarily imperfect and may systematically bias the agency's inflation estimates. The so-called substitution effect—when the price of one good increases faster than prices in general and consumers buy less of that good and purchase other goods instead—must also be taken into account. To better address that effect, BLS developed the chained CPI. However, the use of that alternative measure in setting the COLA would be a difficult change to implement because the chained index is subject to revision.

An argument against reducing the COLA is that Social Security beneficiaries may face prices that grow faster than those for the population as a whole. For example, beneficiaries are likely to spend more than younger people do for medical care, the price of which generally increases faster than overall inflation. BLS computes an experimental consumer price index for the elderly (the CPI-E), which aims to track inflation for the population ages 62 and older. From 1983 through September 2006, the CPI-E grew faster than the CPI-W by an average of

0.3 percentage points per year. The difference was mainly attributable to costs for medical care, which rose 2.6 percentage points faster than the CPI-W as a whole.

Another potential drawback of this option is that a reduction in the COLA would generally have a larger effect on the oldest beneficiaries and on those who initially became eligible for Social Security on the basis of a disability. For example, if benefits were adjusted every year by 0.3 percentage points less than the increase in the CPI-W, beneficiaries would face a reduction in benefits at age 75 of about 4 percent compared with what they could have received under current law; at age 95, they would face a reduction of about 9 percent. To protect vulnerable populations, lawmakers might choose to reduce the COLA only for beneficiaries whose income or benefits were greater than specified amounts. Doing so, however, would reduce the option's potential savings.

RELATED OPTIONS: 600-3, 650-5, 650-6, and Revenue Option 6

650-2—Mandatory

Lengthen the Computation Period for Social Security Benefits by Three Years

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-50	-250	-750	-1,500	-2,500	-5,050	-40,800

As required by law, the Social Security Administration calculates retirement benefits on the basis of a worker's wage history, using the average indexed monthly earnings, or AIME. The present formula computes the AIME on the basis of the beneficiary's highest 35 years of earnings that are subject to Social Security taxes.

This option would gradually lengthen the AIME computation period to 38 years of earnings for people who turn 62 in 2010 and beyond. The extended averaging period would generally reduce benefits by requiring that additional years of lower earnings be factored in to the benefit computation.

Lengthening the computation period by three years would reduce federal outlays by $50 million in 2008 and by $5.1 billion through 2012. By 2050, enacting such reforms would have reduced Social Security outlays by 1.9 percent—or, measured as a share of gross domestic product, from 6.5 percent to 6.4 percent.

An argument that supports expanding the computation period is based on continuing increases in life expectancy. Because people are now living longer, stretching the period would encourage them to remain in the labor force longer and would extend the amount of time they paid into the Social Security system. Extending the averaging period would also reduce the advantage currently enjoyed by some workers who postpone entering the labor force. For instance, workers who delay entering the workforce in order to pursue advanced education can generally count on higher annual wages than their counterparts who entered the labor force at a younger age but obtained jobs with lower annual wages. Because many years of low or no earnings can now be ignored in calculating the AIME, the former group experiences little or no loss of benefits for any additional years spent not working and thus not paying Social Security taxes.

An argument against this option is that some beneficiaries retire early because of circumstances outside of their control, such as poor health or job loss, and this option could adversely affect those recipients who were least able to continue working. Other workers who would be disproportionately affected include those who did not work for significant periods, such as parents who interrupted a career to raise children or workers who experienced long stretches of unemployment.

650-3—Mandatory

Eliminate Social Security Benefits for Children of Early Retirees

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-100	-200	-500	-800	-1,000	-2,600	-8,500

Social Security provides benefits not just to retirees but to their dependents as well. The unmarried children of retired workers, for instance, generally qualify for Social Security benefits under the following circumstances: if they are under age 18, if they are 18 and still in high school, or if they become disabled before age 22. A child's benefit is equal to one-half of his or her parent's basic benefit, subject to a dollar limit on the total amount that a given family may receive.

This option would eliminate benefits for children of retirees who have not yet reached the normal retirement age (NRA), beginning with retirees who will reach age 62 in January 2008. The option would reduce federal outlays by $100 million in 2008 and by $2.6 billion over the 2008–2012 period.

An advantage of this option is that it would encourage some would-be early retirees to remain in the labor force longer. At present, benefits for retired workers and their spouses are reduced if retirement occurs before the normal retirement age, but children's benefits are not reduced. An additional consideration is that younger workers are more likely than their older counterparts to have children under the age of 18. Thus, workers who have not yet reached the NRA currently have an incentive to retire while their offspring are still eligible for benefits. (That incentive is quite small for families in which spouses are also entitled to dependents' benefits. Because of the limit on total family benefits, any increase that is attributable to a family's eligible children in such cases may not exceed 38 percent of the amount on which a worker's benefits are based.)

A potential disadvantage of this option is that for workers whose retirement was not voluntary—who, for example, retired because of poor health but did not qualify for disability benefits—the loss of family income under the option might result in financial hardship. Moreover, because spouses who are younger than age 62 receive benefits only if they have children who are under age 16 or are disabled, eliminating children's benefits for families of early retirees would result in a total loss of benefits for spouses in those families. In such cases, the loss of income generally would be significant. (The option could be adjusted so that those spouses continued to receive benefits, but in that case, the reduction in outlays would be slightly smaller.)

A modified approach to this option would apply the same actuarial reduction to children's benefits that was applied to workers' benefits. Thus, the child of a worker who retired three years before the normal retirement age would receive a maximum of 40 percent of the parent's basic benefit instead of the 50 percent that is currently allowed. The total reduction in outlays would, depending on the year being considered, represent a quarter to a half of the potential savings from eliminating benefits for children of early retirees. Although such a modified approach would have a smaller effect on federal outlays than the elimination of benefits would have, it would protect workers who had young children from experiencing large losses in benefits. However, that approach would also retain most of the incentive for workers to retire early.

650-4—Mandatory

Require Children Under Age 18 to Attend School Full Time as a Condition of Eligibility for Social Security Benefits

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-25	-100	-175	-175	-200	-700	-1,725

Unmarried children of retired, disabled, or deceased workers may qualify for Social Security benefits if they are less than 18 years of age, regardless of their educational status. Once children turn 18, benefits generally continue only for those who are enrolled in secondary school.

Such children continue to be eligible for benefits until the second month after they turn 19 or until they complete the school year in which they celebrate their 19th birthday—whichever comes first. To qualify for benefits before that cutoff date, those older children must provide the Social Security Administration (SSA) with a statement by a school official certifying their attendance. (A student is not required to attend school during summer breaks if he or she plans to return to school in the fall.) Students who are being homeschooled or are participating in GED (General Education Development) programs may qualify for benefits, depending on the laws in their state. In December 2005, SSA paid benefits to about 127,000 student beneficiaries. (Fifty percent of those students were survivors of deceased beneficiaries, about 40 percent were children of disabled workers, and the remainder were children of retired workers.)

This option, which is included in the President's 2008 budget request, would extend the attendance requirement to child beneficiaries who are age 16 or 17 and who have not graduated from high school. No benefits would be paid for any month in which the child did not meet the requirement of full-time school attendance.

In 2005, 785,000 16- and 17-year-olds received a total of about $4.5 billion in Social Security benefits. About 5 percent of those beneficiaries did not attend school. The Congressional Budget Office's estimates of the reductions in outlays under this option incorporate the assumption—which is highly uncertain—that the option would reduce the number of those dropouts by one-quarter. Under that assumption, outlays would fall by about $25 million in 2008 and by $700 million over five years.

Proponents of this option note that it would encourage children who are eligible for the benefit to remain in school. However, an argument against the option is that by requiring SSA to collect attendance information on 16- and 17-year-old beneficiaries, the option would increase the agency's administrative costs as well as the costs to schools and affected beneficiaries. In addition, opponents say, the option could reduce benefits for families with children who do not attend school because of mental or emotional disabilities. SSA could make exceptions in such cases, but doing so would increase administrative costs and could entail delays in benefits. Another argument against the option is that it would reduce the income of affected families, who might already be facing financial pressures because of a parent's death or disability.

650-5—Mandatory

Raise the Normal Retirement Age in Social Security

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-50	-250	-700	-1,500	-3,600	-6,200	-86,200

Under current law, the age at which workers become eligible for full retirement benefits—known as the normal retirement age, or NRA—varies, depending on the individual's year of birth. For workers born before 1938, the NRA is 65. For workers born in subsequent years, the eligibility age increases in two-month increments until it reaches 66 for workers born in 1943. For workers born between 1944 and 1954, the NRA remains at 66 but rises, again in two-month increments, until it reaches 67 for workers born in 1960 or later. Workers can still receive benefits at age 62, but the benefit they receive at that age will represent a smaller share of what they could have qualified for if they had waited until the normal retirement age to claim benefits.[1]

Under this option, the NRA would begin to increase for workers born in 1946 (who turn 62 in 2008) and would reach 67 for workers born in 1951. Thereafter, the retirement age would increase by two months a year until it reached 70 for workers born in 1969. After that, it would increase by one month every other year. As under current law, workers would still be able to begin receiving reduced benefits at age 62, but the amount of the reductions would be larger. For most purposes, this approach to constraining the growth of benefits is equivalent to reducing earnings-replacement rates. (See Option 650-6 for a more direct method of reducing those rates.) However, the benefits of workers who qualify for disability insurance would not be reduced under this approach.

This option would shrink federal outlays by $50 million in 2008 and by $6.2 billion over five years. By 2050, the option would have reduced Social Security outlays by 14 percent—or, measured relative to the size of the economy, from 6.5 percent of gross domestic product to 5.6 percent.

A rationale for this option is that people who turn 65 today will, on average, live to collect Social Security benefits for significantly longer than retirees did in the past, and life expectancy is projected to continue to increase. For example, over the next 25 years, the Social Security trustees project that life expectancy at age 65 will increase from 18.4 years to 19.9 years. Therefore, a commitment to provide retired workers with a certain monthly benefit at age 65 in 2030 is more costly than that same commitment made to today's recipients.[2] Linking the normal retirement age to future increases in life expectancy is one way of dealing with that source of the program's rising costs.

An argument against this option is that it would create a somewhat stronger incentive for older workers nearing retirement to apply for disability benefits as a way to receive a higher monthly benefit amount. For instance, under current law, workers who retired at age 62 in 2029 would receive 70 percent of their primary insurance amount, or PIA (the benefit they would have received if they had claimed benefits at their normal retirement age); if they qualified for disability benefits, however, they would receive 100 percent of their PIA. Under this option, workers who retired at 62 in 2031 would receive only 55 percent of their PIA, but they would still receive 100 percent if they qualified for disability benefits. To eliminate that added incentive to apply for disability benefits, policymakers could narrow that difference by also reducing scheduled disability payments—for example, by setting the benefits for disabled workers at the level they would have received upon retiring at age 65.

1. See www.ssa.gov/OACT/ProgData/ar_drc.html for a table of NRAs by birth year and details of how the age at which benefits are first claimed affects monthly benefit amounts.

2. See Congressional Budget Office, *Measuring Changes to Social Security Benefits* (December 1, 2003).

RELATED OPTIONS: 570-1, 650-1, and 650-6

RELATED CBO PUBLICATION: *Measuring Changes to Social Security Benefits*, December 1, 2003

650-6—Mandatory

Constrain the Increase in Initial Social Security Benefits

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Implement pure price indexing	-150	-750	-1,925	-3,900	-6,850	-13,600	-141,100
Implement progressive price indexing	-25	-350	-1,000	-2,025	-3,600	-7,000	-73,100

Social Security benefits for retired and disabled workers are based on those individuals' average level of earnings over their working lifetime. The Social Security Administration (SSA) uses a formula to compute a worker's initial benefit; in that computation, it adjusts the benefit formula to take into account the average economywide growth of wages—a process known as wage indexing. As a result of that indexing, average benefits for Social Security recipients grow at the same rate as do average wages, and such benefits replace a constant portion of those wages. (After people become eligible for benefits, their monthly payment is also adjusted each year to take into account increases in the cost of living.)[1]

One way to constrain the growth of Social Security benefits would be by changing the initial benefit computation so that the real (inflation-adjusted) value of average initial benefits would no longer rise over time. Under such an approach, which is often called price indexing, increases in real wages would still result in higher real Social Security payroll taxes but would no longer result in higher real benefits. Specifically, this option would link the growth of initial benefits to the growth of prices (as measured by changes in the consumer price index) rather than to the growth of average wages, beginning with participants who became eligible for benefits in 2008. (Under the option, the formula would actually continue to be indexed to wages. The benefit generated by that formula would then be reduced by the ratio of the price level to the average wage level.) Such a switch to indexing initial benefits on the basis of prices rather than wages—a so-called pure price-indexing approach—would reduce federal outlays by $150 million in 2008 and by $13.6 billion over five years. By 2050, the option would have reduced Social Security outlays by 31 percent—or, measured relative to the size of the economy, from 6.5 percent of gross domestic product to 4.5 percent.

Under pure price indexing, the reduction in payments relative to those that are scheduled to be paid under current law would be larger for each successive cohort of beneficiaries after 2008, and the extent of the reduction would be determined by the growth of real wages in future years. For example, if real wages grew by 1.2 percent annually (which is approximately the assumption incorporated in the Congressional Budget Office's long-term Social Security projections), workers who were first eligible for benefits in 2030 would receive 24 percent less than they would have received under the current rules; those eligible for benefits in 2050 would receive 40 percent less.

An alternative approach, progressive price indexing, would retain the current formula for workers who had lower earnings, reducing the growth of initial benefits only for workers who had higher earnings. The President indicated support for that idea in his 2008 budget submission.[2]

Currently, the formula for calculating initial Social Security benefits is structured so that workers who have higher earnings receive higher benefits, but the benefits paid to workers who have lower earnings replace a larger share of their earnings. Under progressive price indexing, benefits for the 30 percent of workers who had the lowest lifetime earnings would grow with average wages, as they are currently slated to do. Initial benefits for higher-income workers would grow more slowly, at a rate that corresponded to their position in the distribution of earnings. For example, for workers whose earnings put them at the 31st percentile of the distribution, benefits would grow only slightly more slowly than wages, whereas for the

1. For a fuller explanation of how benefits are computed, see Congressional Budget Office, *Social Security: A Primer* (September 2001), pp. 19–24.

2. *Budget of the U.S. Government, Fiscal Year 2008,* p. 144.

highest earners, benefits would grow with prices—as they would under pure price indexing. The benefit formula would gradually become flatter, and after about 70 years, the top 70 percent of earners would all be receiving the same monthly benefit.

Under progressive price indexing, initial benefits for the majority of workers would grow more quickly than prices but more slowly than average wages. A switch to progressive price indexing would reduce federal outlays by $25 million in 2008 and by $7 billion over five years. By 2050, outlays for Social Security would have been reduced by 20 percent, or from 6.5 percent of gross domestic product to 5.2 percent.

An advantage of both price-indexing approaches is that they would reduce outlays for Social Security compared with those scheduled to be paid under current law but real average benefits in the program would not decline. If the pure price-indexing approach was followed, future beneficiaries would generally receive not only the same real monthly benefit paid to current beneficiaries but also, as average longevity increased, a larger total lifetime benefit. However, a disadvantage of that approach is that benefits would replace a smaller portion of workers' earnings than they do today.[3]

Progressive price indexing would reduce scheduled Social Security outlays by a smaller amount than would pure price indexing, and beneficiaries who had lower earnings would not be affected. Real annual average benefits would still increase for all but the highest-earning beneficiaries. Benefits would replace a smaller portion of affected workers' earnings than they do today but a larger portion than they would under pure price indexing.

Under both price-indexing approaches, the reductions in benefits relative to current law would be greatest for beneficiaries in the distant future. Those beneficiaries, however, would have had higher real earnings during their working years and thus a greater ability to save for retirement.

3. See Congressional Budget Office, *Measuring Changes to Social Security Benefits* (December 2003).

RELATED OPTIONS: 650-1 and 650-5

RELATED CBO PUBLICATIONS: *Long-Term Analysis of S. 2427, the Sustainable Solvency First Act of 2006,* April 5, 2006; *Menu of Social Security Options,* May 25, 2005; *Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security,* July 21, 2004; *Measuring Changes to Social Security Benefits*, December 1, 2003; and *Social Security: A Primer*, September 2001

650-7—Mandatory

Require State and Local Pension Plans to Share Data with the Social Security Administration

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	0	0	0	-150	-300	-450	-2,300

Two provisions of Social Security law—the government pension offset and windfall elimination—reduce benefits for individuals who receive pension income resulting from work that was not covered by Social Security—for example, some jobs in state and local government.[1] To accurately apply those provisions, the Social Security Administration (SSA) must know which Social Security beneficiaries are receiving pension income based on noncovered employment. The Office of Personnel Management provides data to SSA that identify workers who receive pension benefits from the federal government, but SSA relies largely on beneficiaries to report any such income they receive from state or local governments.

This option, which is included in the President's 2008 budget request, would require state and local governments to inform SSA of pension benefits from noncovered employment that they are providing to retirees or other beneficiaries. Developing and implementing a system to collect and administer that information would take several years, but when it was fully phased in, it would result in lower Social Security payments for about 60,000 individuals annually, reducing federal outlays by about $150 million in 2011 and by $450 million through 2012. A substantial portion of that estimated change in spending—about half of it in 2011, declining to 15 percent by 2017—would stem from recovering past overpayments of benefits through reductions in future payments to beneficiaries who had state and local pension income they had not reported.

The standard formula for Social Security benefits is structured to replace a larger portion of earnings for workers whose career earnings were low than the portion it replaces for higher-earning workers. But that formula does not differentiate between workers whose career earnings are actually low and workers who appear to have low career earnings only because a portion of their past employment was in a job that was not covered by Social Security. If the standard formula was applied without an adjustment for that circumstance, recipients of government pension income would receive benefits that, relative to their Social Security payroll taxes, would be larger than those received by other workers with similar lifetime earnings. The windfall elimination provision offsets that extra benefit.

Under the standard benefit formula, some beneficiaries—known as dependent spouses—collect retirement benefits that are based on the earnings of their spouses or ex-spouses. If the primary earner is retired or disabled, the dependent spouse may generally receive benefits equal to half the primary earner's benefits; if the primary earner is deceased, the dependent spouse may generally receive benefits equal to the primary earner's. In both cases, spousal benefits are effectively reduced dollar for dollar by any Social Security benefits that the dependent spouse has earned on his or her own. Under the government pension offset, spousal benefits are also reduced but by $2 for every $3 in pension benefits from government employment not covered by Social Security. That approach effectively treats two-thirds of the pension income from noncovered employment as equivalent to Social Security benefits.

Although beneficiaries subject to the government pension offset or windfall elimination provision are required to inform SSA if they receive pension benefits from noncovered jobs, SSA does not obtain that information in about 4 percent of cases. Under this option, state and local governments would be required to provide the necessary data in electronic form—which would give SSA access to the same data on state and local government pension income that they currently have for federal pension benefits.

1. See Congressional Research Service, *Social Security: The Government Pension Offset (GPO)*, CRS Report for Congress RL32453 (updated April 8, 2005), and *Social Security: The Windfall Elimination Provision (WEP)*, CRS Report for Congress 98-35 (updated January 3, 2006).

An advantage of this option is that it would allow SSA to compute benefits more accurately. Federal pensioners and state and local pensioners are typically subject to the government pension offset and windfall elimination provision; however, state and local pensioners who fail to accurately report their pension information to SSA may receive larger benefits than they are legally eligible for.

A disadvantage of this option is that it would increase the administrative burden of state and local governments. Those agencies, however, already provide data on individuals' pension income to the Internal Revenue Service on Form 1099R, so the additional costs for administering the option would be relatively small.

650-8—Mandatory

Eliminate the Social Security Lump-Sum Death Benefit

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-175	-200	-200	-200	-200	-1,000	-2,050

When a Social Security beneficiary who is living with a spouse dies, the spouse receives a lump-sum death benefit of $255. The payment may also go to a spouse who was not living with the deceased beneficiary but was eligible for Social Security benefits on the basis of the beneficiary's earnings record. If the deceased beneficiary had no spouse but did have a child who was eligible for dependent benefits, the death benefit is paid to the child. (No payment is made if there is no eligible spouse or child.) The Social Security Administration (SSA) pays a lump-sum death benefit about 45 percent of the time when an insured individual dies. In calendar year 2005, it made about 830,000 payments, which accounted for outlays of $211 million.

This option would eliminate lump-sum death payments for beneficiaries who died after September 30, 2007, which would reduce federal outlays by $175 million in 2008 and by $1.0 billion through 2012.

Although the original 1935 Social Security Act did not provide for survivors' benefits, it included a lump-sum benefit to be paid if a worker died before the statutory retirement age.[1] When monthly survivors' benefits were introduced in 1939, the lump-sum death benefit was changed and paid only in cases in which no one was entitled to survivors' benefits on the basis of the deceased person's earnings. The lump-sum death benefit went either to a family member or to an individual who helped pay burial expenses. The amount of the payment was linked to the monthly benefit that the deceased worker would have received had he lived.

In 1950, lawmakers expanded eligibility for the lump-sum benefit, which was provided even when survivors' benefits were also paid. As a result, the SSA paid the benefit in the case of nearly every death, sometimes to distant relatives or funeral homes. In 1954, policymakers capped the benefit at $255. That limit applied more and more frequently, as monthly benefits increased, and by the mid-1970s, virtually all payments were $255. In 1981, legislation narrowed eligibility for the benefit to its current status. (Although the payment is still frequently referred to as a "burial" benefit, it is no longer linked to burial expenses.)

Supporters of eliminating the lump-sum death benefit note that because the payment is small, the cost of administering it, measured as a percentage of the payment, is relatively high: Administrative expenses account for 1 percent of total Social Security outlays but about 7 percent of outlays for the lump-sum death benefit.

Opponents of the option maintain that although the benefit is relatively small, it is of value to many survivors, who receive it at a time of extra financial pressures. If the lump-sum benefit is to be eliminated, opponents argue that such action should be taken as part of a set of broader changes to Social Security that would protect lower-income participants from reductions in their total benefits.

1. The description that follows draws mostly from Larry DeWitt, *The History & Development of the Lump Sum Death Benefit*, Research Note No. 2 (Social Security Administration, Historian's Office, June 1996), available at www.ssa.gov/history/lumpsum.html.

650-9—Mandatory

Reduce the Spousal Benefit in Social Security from 50 Percent to 33 Percent

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-25	-100	-275	-525	-950	-1,900	-17,925

Under current Social Security law, the husband or wife of a worker is entitled to a spousal benefit that is equal to 50 percent of the worker's benefit—if that amount is higher than the spouse's own earned benefit. In such cases, a couple's combined benefit would be 150 percent of the higher earner's benefit. Otherwise, the couple's benefit would be between 150 percent and 200 percent of the higher earner's benefit. (The 200 percent applies only if both spouses earn the same benefit.) Upon the death of either spouse, the survivor's benefit is generally set equal to 100 percent of the higher earner's benefit.

This option would reduce the spousal benefit to 33 percent of the higher-earning spouse's benefit for workers who become eligible for Social Security benefits in 2008 or later. Such an approach would reduce federal outlays by $25 million in 2008 and by $1.9 billion over five years. In the future, those reductions would decline as a portion of total Social Security benefits with the continued narrowing of the gap between the earnings of male and female workers. By 2050, the implementation of this option would have reduced Social Security outlays by 1.1 percent—or, measured as a percentage of gross domestic product, from 6.5 percent to 6.4 percent.

A rationale for implementing this option is that it would strengthen the connection between taxes paid and benefits received. When the current rules for the spousal benefit were established, households in which only the husband worked were considered typical, and the spousal benefit was designed to ensure adequate benefits for such couples. However, those rules weaken the link between the Social Security taxes that are paid and the benefits that are received. Relative to Social Security taxes paid, a one-earner couple currently receives substantially higher benefits than either a single worker who has the same earnings history or a two-earner married couple.

Reducing the couple's benefit has been proposed in combination with increasing the benefit paid to surviving spouses (see Option 650-10); implementing the two changes together would effectively transfer income from couples to survivors. With the death of a spouse, a survivor faces not only reduced Social Security benefits but potentially lost pension and wage income as well. As a result, widows and widowers are more likely than married couples to be poor. In 2004, 4.5 percent of married people over the age of 65 were poor, compared with 14.5 percent of widows and widowers in the same age group.[1]

Moreover, larger households benefit from economies of scale. (For example, the cost of housing that is suitable for two people is usually less than twice that for two people living separately.) Consequently, a two-person household can achieve the same standard of living as two single-person households at less total cost. The Census Bureau's poverty measures, created many years ago, imply that the cost of living for a two-person elderly household is only 26 percent higher than that for a one-person elderly household. If that is correct, a 33 percent spousal benefit would more accurately account for the cost of supporting a two-person household.

An argument against this option is that the economies of household size are hard to compute and may be smaller than the Census Bureau's estimate. A National Research Council panel in 1995 estimated that the costs for a two-person household are about 60 percent higher than a one-person household's costs.[2] That estimate would support retaining the current 50 percent spousal benefit. Another argument against this option is that it would reduce benefits for spouses who stay home to raise children.

1. Social Security Administration, *Income of the Population 55 or Older, 2004* (May 2006), Table 8.1.

2. National Research Council, *Measuring Poverty: A New Approach* (Washington, D.C.: National Academy Press, 1995), pp. 58–60.

650

RELATED OPTION: 650-10

650-10—Mandatory

Increase the Social Security Benefit Paid to Surviving Spouses

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	+17,600	+24,000	+24,900	+25,800	+26,800	+119,000	+268,600

Under the laws that currently govern the Social Security program, a surviving spouse is eligible for between one-half and two-thirds of the total Social Security benefit that would have been paid to the couple if the deceased spouse were still alive.

If the lower-earning spouse qualified for a worker benefit that was less than half of the benefit earned by the higher-earning spouse, the couple's total benefit would be 150 percent of the higher earner's benefit. Upon the death of either spouse, the benefit would generally be reduced to 100 percent of the higher earner's benefit—that is, the survivor's benefit would equal 67 percent of the couple's benefit. If the lower earner's benefit was greater than 50 percent of the higher earner's, the couple's total benefit would simply be the sum of the two benefit amounts. Upon the death of either spouse, however, the survivor's benefit would equal the greater of the two individual benefits. In that case, the survivor's benefit would be less than 67 percent of the couple's benefit and could be as low as 50 percent.

Under this option, the benefit of a surviving spouse would amount to at least 75 percent of the couple's benefit. That change, if implemented, would increase federal outlays by $18 billion in 2008 and by $119 billion over five years. By 2050, the option would have increased Social Security outlays by 3.3 percent—or, measured relative to the size of the economy, from 6.5 percent of gross domestic product to 6.7 percent.

Widows and widowers are more likely than married couples to be poor. In 2004, for example, 4.5 percent of married people over the age of 65 were poor, compared with 14.5 percent of widows and widowers in the same age group.[1] Increasing the survivor's benefit has been proposed in combination with a reduction in the couple's benefit (see Option 650-9). Implementing the two changes together would effectively transfer income from couples to survivors.

A rationale for this option is that it would make the Social Security program more equitable. Although single-earner couples benefit greatly from the spousal benefit, two-earner couples may not benefit at all. The greatest beneficiaries of this approach would be the surviving spouses of two-earner couples in which the two individuals had relatively equal benefit amounts. Under this option, those survivors' benefits would increase by 50 percent. Survivors of single-earner couples—who gain the most from the spousal benefit—would gain less under the option. Their benefit would increase from 67 percent to 75 percent of the couple's benefit.

An argument against this option is that it would not target beneficiaries who were most in need. For instance, even survivors with relatively high Social Security benefits or with substantial income from other sources would benefit. However, to help reduce costs, the option could be limited to certain beneficiaries. For example, in 2001, the President's Commission to Strengthen Social Security proposed that a surviving spouse receive 75 percent of the couple's benefit, but if that amount was greater than the individual benefit earned by the average worker, it would be reduced to the average benefit amount. Such an approach would reduce the cost of this option by almost 90 percent.

1. Social Security Administration, *Income of the Population 55 or Older, 2004* (May 2006), Table 8.1.

RELATED OPTION: 650-9

650-11—Mandatory

Increase Social Security Benefits for Workers Who Have Low Earnings Over a Long Working Lifetime

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	+400	+1,700	+3,900	+6,700	+10,100	+22,800	+137,000

Social Security benefits are generally calculated on the basis of a worker's average wages over the course of his or her career. Under the standard formula, benefits are the same regardless of whether recipients had low lifetime earnings because they were out of the workforce for many years or because they consistently received low earnings over many years of work. Recognizing that workers with consistently low annual earnings are more likely to be in financial need, policymakers established a second formula—the "special minimum benefit"—in Social Security in 1972.[1]

Under that provision, participants receive the higher of the standard benefit or the special minimum benefit. Unlike the standard formula, in which average benefits grow with average wages, the special minimum formula is indexed to prices. As a result, the gap between the two formulas is continually shrinking. Each year, fewer people gain from the minimum benefit; those who do, gain less. The special minimum is projected to provide no benefit to workers who become eligible in 2010 and later.

This option, which was an element of Plan 2 of the President's 2001 Commission to Strengthen Social Security, would replace the special minimum benefit with an enhancement for participants who worked many years but had low average wages. The provision would apply to workers who become eligible to claim benefits in 2008 and later. All benefits would be based on the standard formula, but benefits for some workers would be multiplied by an additional factor. The option would increase federal outlays by $400 million in 2008 and by $22.8 billion over five years, amounts that include offsetting savings in the federal share of the Supplemental Security Income and Medicaid programs. By 2050, the option would have increased Social Security outlays by 5.5 percent—or, measured relative to the size of the economy, from 6.5 percent of gross domestic product to 6.9 percent.

This option would increase the standard benefit for workers who had more than 20 years of work to their credit but whose average indexed monthly earnings were below those of workers who earned twice the minimum wage for 35 years of full-time work. The effect of the option would be greater for those beneficiaries who had more years of work and for those who had lower average indexed monthly earnings. For example, the benefit for workers who worked full time for 30 years but never earned more than the minimum wage would be increased by 40 percent.

Although a rationale for this option is that it would help those workers whom the special minimum benefit was also designed to assist—workers who had a history of consistently low annual earnings—a drawback to the enhanced benefit is that it would not distinguish between those who had low annual earnings because they earned low hourly wages and those who had higher hourly wages but elected to work for only part of the year.

1. See Kelly A. Olsen and Don Hoffmeyer, "Social Security's Special Minimum Benefit," *Social Security Bulletin*, vol. 64, no. 2 (2001/2002), pp. 1–15.

700

Veterans Benefits and Services

Benefit programs for military veterans, most of them run by the Department of Veterans Affairs (VA), include health care, disability compensation, pensions, life insurance, housing loans, education, training, and vocational rehabilitation. The Congressional Budget Office estimates that outlays for budget function 700 will total about $72 billion in 2007, including $35 billion in discretionary outlays.

In recent years, lawmakers have expanded health and education benefits for veterans, thus increasing spending on those programs. Medical care outlays, which are subject to appropriation, rose from roughly $22 billion in 2002 to almost $30 billion in 2006, an increase of 34 percent. Mandatory spending for education, training, and vocational rehabilitation benefits increased from $1.7 billion in 2002 to $2.6 billion in 2006. Most of the increases occurred in 2003 and 2004 because of larger caseloads and legislated increases in benefits.

Spending on disability compensation, a mandatory program, also increased significantly—by 40 percent over five years—from about $22 billion in 2002 (adjusted to reflect a shift in the date of the monthly payments) to about $31 billion in 2006. That growth resulted primarily from the increased caseloads arising from a push by VA to reduce a backlog of pending cases and from the addition of newly compensable diseases.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	24.0	26.6	29.2	32.3	34.2	36.5	9.2	6.6
Outlays								
Discretionary	24.1	25.7	28.6	30.5	32.4	35.0	7.7	8.0
Mandatory	26.9	31.3	31.2	39.7	37.4	37.3	8.6	-0.2
Total	51.0	57.0	59.8	70.2	69.8	72.3	8.2	3.6

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

700-1—Discretionary and Mandatory

Require Copayments for All Non-Service-Connected VA Medical Care

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Discretionary	-616	-638	-658	-679	-699	-3,290	-7,120
Mandatory	+51	+53	+54	+56	+58	+271	+586

Note: Discretionary savings accrue to the Department of Veterans Affairs; increases in mandatory outlays are projected for the Medicare and Medicaid programs.

In 2005, almost 5 million veterans received medical care from the Department of Veterans Affairs (VA). Every VA patient is enrolled in one of eight priority care groups, as determined by income, disability status, and other factors. In January 2003, VA froze enrollment in Group 8, the lowest group, which consists of veterans who do not have service-connected disabilities and whose income is above both a VA income threshold and a geographic income index established by the Department of Housing and Urban Development. Currently, veterans in Priority Groups 6 to 8, the lowest priority groups, are charged copayments (and the health plans of any who have private insurance may be billed) for treatment of non-service-connected conditions.

This option would increase out-of-pocket costs for veterans in Priority Group 5—those who do not have service-connected disabilities and whose incomes are below a VA-defined threshold. This option is targeted toward the group that consumes the greatest share of VA medical resources each year: Priority Group 5 veterans constitute 36 percent of VA enrollees and consume 40 percent of VA medical resources. Currently, those patients pay no fees for inpatient or outpatient medical care, although those who earn more than the VA pension level ($11,000 or more per year, depending on whether the veteran has a spouse or dependents) pay $8 per prescription, up to an annual cap of $960. The Congressional Budget Office estimates that increased cost sharing for Priority Group 5 veterans will reduce discretionary spending for VA medical services by $616 million but will increase mandatory spending for Medicare and Medicaid by $51 million in 2008. Over the 10-year period from 2008 through 2017, this option would reduce discretionary outlays by $7.1 billion but would increase mandatory outlays by $586 million.

One rationale for this option is that increased cost sharing for Priority Group 5 veterans could reduce VA spending by making those veterans more cost-conscious in their demand for health care. CBO's assessment of the impact of introducing small fees assumed that those fees would be waived after a patient reached a monthly maximum for out-of-pocket payments.

An argument against this option is that it focuses on one of the poorest groups of veterans and leaves unchanged the out-of-pocket expense for those in lower-priority groups. Veterans in Priority Groups 6 to 8—a population that is expected to consume 13 percent of VA's medical resources in 2007—do make copayments for the services they receive and their insurance plans (if any) are billed, but the revenue from those two sources covers less than a quarter of the cost of their care. (Net of copayments, veterans in Groups 6 to 8 consume only 10 percent of VA medical resources.) Because the veterans in Groups 6 to 8 have more income, another argument against the option is that VA should concentrate first on recovering costs from them, although policy changes aimed at reducing the net cost of care for veterans in those lower-priority groups are unlikely to substantially reduce growth in VA medical spending.

RELATED OPTION: 700-2

RELATED CBO PUBLICATIONS: Statement of Allison Percy, Principal Analyst, National Security Division, Congressional Budget Office, *Future Medical Spending by the Department of Veterans Affairs*, February 15, 2007; *Potential Growth Paths for Medical Spending by the Department of Veterans Affairs,* July 14, 2006; and *The Potential Cost of Meeting Demand for Veterans' Health Care,* March 2005

700-2—Discretionary and Mandatory

Close Enrollment in VA Medical Care for Priority 7 and 8 Veterans

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays							
Discretionary	-2,232	-2,502	0	0	0	-4,734	-4,734
Mandatory	+1,900	+1,950	0	0	0	+3,850	+3,850

Note: Discretionary savings accrue to the Department of Veterans Affairs; increases in mandatory outlays are projected for the Medicare program.

Veterans who seek medical care from the Department of Veterans Affairs (VA) are enrolled in one of eight priority care groups defined by income, disability status, and other factors. Veterans in Priority Group 8 are those without service-connected disabilities whose income and assets are above both a VA means test threshold and a geographic income index established by the Department of Housing and Urban Development (HUD). Priority Group 7 veterans have no service-connected disabilities, and their incomes fall below the HUD geographic index but above the VA threshold. About 537,000 veterans are now in Priority Group 7; 1.7 million are in Priority Group 8. Veterans in those groups make copayments for their care, and if they have private health insurance, VA bills their health plans. However, those sources cover only about a quarter of the cost of their care. In 2006, the net cost to VA was over $2 billion, or about 9 percent of VA's total budget for medical care. When the priority system was established in 1999, the Secretary of Veterans Affairs was charged with deciding how many priority groups VA could serve each year; VA medical costs have grown nearly 75 percent since then. In 2003, new enrollment of Priority Group 8 veterans was cut off; those who were already enrolled remained in the program.

This option would close enrollment for Priority Group 7 veterans and disenroll all Group 7 and 8 veterans, thus curtailing VA spending for veterans who are not poor and who do not have service-related medical needs. To be eligible for VA medical services, a veteran would need to qualify for a higher-priority group by demonstrating a service-connected disability, by documenting income below the VA threshold, or by showing qualification under other criteria (such as Agent Orange exposure, Purple Heart or former prisoner of war status, Medicaid eligibility, or catastrophic non-service-connected disability). The Congressional Budget Office estimates that disenrolling all Priority 7 and Priority 8 veterans will reduce discretionary outlays by $2.2 billion in 2008 and by $4.7 billion from 2008 to 2012. That policy would also increase mandatory spending for Medicare by $1.9 billion in 2008 and by $3.9 billion from 2008 to 2012. The VA medical budget could be reduced by $2.2 billion in 2008, CBO estimates, while still providing the current level of services to veterans in Priority Groups 1 through 6.

CBO's estimate of federal savings for this option is affected by the assumptions it uses in its baseline projections of discretionary spending. In CBO's baseline projections, appropriations for the Veterans Health Administration (VHA) grow by about 3 percent per year over the next 10 years. If VA medical spending grew at that rate, VA could be forced to disenroll all veterans in Priority Groups 7 and 8 by 2010. Because those veterans would already be disenrolled, under the baseline assumptions, the net federal savings from this budget option would be zero from that date onward. However, VHA appropriations have grown at more than twice the baseline rate in recent years. If the Congress follows recent trends and appropriates higher amounts, VA would not have to disenroll Priority 7 and 8 veterans. In that case, the reduction in discretionary outlays from disenrolling veterans under this budget option would rise to $27.2 billion (not shown in the table) over the 10 years from 2008 through 2017, and the increase in mandatory spending for Medicare would rise to $21.3 billion over that period.

A rationale for this option is that almost 90 percent of Priority Group 7 and 8 veterans have other public or private health insurance coverage and receive only a portion of their care from VA. Those veterans could seek care from other sources. An argument against this option is that many of those veterans rely on VA as their primary medical care provider. Some will not have easy access to other services without substantial out-of-pocket expense, and many will turn to Medicare or other public programs. The result would be a relatively small net decrease in federal spending.

RELATED OPTION: 700-2

RELATED CBO PUBLICATIONS: Statement of Allison Percy, Principal Analyst, National Security Division, Congressional Budget Office, *Future Medical Spending by the Department of Veterans Affairs*, February 15, 2007; *Potential Growth Paths for Medical Spending by the Department of Veterans Affairs,* July 2006; and *The Potential Cost of Meeting Demand for Veterans' Health Care,* March 2005

700-3—Mandatory

Increase Beneficiaries' Cost Sharing for Care at VA Nursing Facilities

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-206	-213	-219	-226	-232	-1,096	-2,365
Outlays	-186	-210	-217	-224	-230	-1,066	-2,325

Subject to the availability of resources, veterans are eligible to receive long-term care in nursing homes operated by the Department of Veterans Affairs (VA). That care is made available primarily on the basis of the nature of the disability and the veteran's income. Under some conditions, a veteran may receive care at VA's expense in state-operated or privately run nursing care facilities. When veterans receive more than 21 days of care in VA nursing homes, VA can charge copayments to patients whose income meets a specific threshold and who have no compensable service-connected disabilities. In 2007, VA may collect up to $6 million for extended-care services, including nursing home care, the Congressional Budget Office estimates. Under current law, those collections are treated as offsets to discretionary spending that is subject to annual appropriation. CBO assumes in its baseline that those receipts are appropriated each year. Yet VA does not recover costs to the same degree as do state-operated nursing homes, which, according to the Government Accountability Office, can offset as much as a third of their operating expenses through copayments charged to veterans.

This option would authorize VA to revise its cost-sharing policies to recover more of the costs of providing care in its nursing homes. The department would strive to collect a minimum of 10 percent of the overall cost of providing care, but it could determine what type of copayments to charge and who would pay them. For example, it could apply the copayment to a broader category of veterans or require those veterans who make copayments to pay more. Recovering 10 percent of VA's operating costs would save $186 million in 2008 and about $1.1 billion over five years. Achieving those savings would require depositing the receipts in the Treasury rather than allowing VA to spend them.

One justification for this option is that patients in VA nursing facilities receive a more generous benefit than do veterans in non-VA facilities. Recovering more of the expense at VA facilities would make distribution of that benefit more equitable among veterans and across different sites of care.

However, beneficiaries in nursing facilities might be less able to make copayments than are beneficiaries who receive other types of care. In addition, a policy that allows VA to charge veterans with service-connected disabilities would be inconsistent with the standard reflected by other medical benefits that those veterans receive. In implementing this option, VA could continue to exempt those veterans; however, it would have to charge veterans with higher income but without service-connected disabilities even more to achieve the 10 percent recovery.

700-4—Mandatory

Narrow the Eligibility for Veterans' Disability Compensation to Include Only Veterans with High-Rated Disabilities

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-96	-179	-252	-328	-436	-1,291	-4,629
Outlays	-88	-172	-246	-321	-434	-1,261	-4,569

Approximately 2.7 million veterans who have service-connected disabilities receive disability compensation benefits from the Department of Veterans Affairs (VA). The amount of compensation is based on a rating of individual impairment that is intended to reflect the resulting reduction, on average, in the veteran's earnings capacity. Disability ratings range from zero to 100 percent (the most severe), and those who cannot maintain gainful employment and who have ratings of at least 60 percent are eligible to be paid at the 100 percent disability rate. Veterans who have disabilities rated 30 percent or higher and who have dependent spouses, children, or parents are paid special allowances because of their dependents. The Congressional Budget Office estimates that at least 51,000 more veterans with disability ratings below 30 percent will begin receiving compensation of $75 to $220 per month (plus a cost-of-living increase) each year from 2008 to 2017.

This option would, for all future cases, narrow eligibility for compensation to include only veterans with disability ratings of 30 percent or higher. The change would reduce federal outlays by $1.3 billion from 2008 to 2012.

A rationale for this option is that it would permit VA to concentrate spending on the veterans with the greatest impairments. Furthermore, the need for compensating veterans with the mildest impairments could be lessening. Many civilian jobs depend less now on physical labor than was the case in 1924, when the disability-rating system was devised. Medical care and rehabilitation techniques and technology also have made great progress. Thus, a physical impairment rated below 30 percent (for example, mild arthritis, moderately flat feet, or loss of part of a finger) might not substantively reduce a veteran's earning ability because it would not preclude work in many modern occupations.

One argument against this option is that veterans' compensation could be viewed as career or lifetime indemnification the federal government owes to people who become disabled to any degree while serving in the armed forces. Moreover, some disabled veterans might find it difficult to replace the income provided through the compensation payments.

RELATED OPTIONS: 700-5 and 700-6

700-5—Mandatory

Narrow the Eligibility for Veterans' Disability Compensation to Veterans Whose Disabilities Are Related to Their Military Duties

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-20	-56	-91	-133	-141	-441	-1,664
Outlays	-17	-53	-88	-130	-138	-427	-1,632

Veterans are eligible for disability compensation if they receive or aggravate disabilities (excluding those resulting from willful misconduct) while in active-duty service. For the Department of Veterans Affairs (VA) to consider a disability as service connected, the service member need not have been performing military duties when the disability was incurred or exacerbated; for example, a qualifying disability can be incurred when a service member is on leave. The federal government also gives dependency and indemnity compensation awards to survivors when compensable disabilities cause or are related to a veteran's death. According to data collected by VA, in 2006 about 308,000 veterans received a total of approximately $1.3 billion in compensation payments for disabilities that, according to the Government Accountability Office, are generally neither caused nor aggravated by military service. Excluding diabetes mellitus, which VA has since determined to be service connected for certain Vietnam veterans, the conditions that trigger disability payments are osteoarthritis, chronic obstructive pulmonary disease (including chronic bronchitis and pulmonary emphysema), arteriosclerotic heart disease, Crohn's disease, hemorrhoids, uterine fibroids, and multiple sclerosis.

This option would end new compensation benefits for veterans with those seven conditions, saving $17 million in outlays in 2008 and $427 million between 2008 and 2012. Eliminating new compensation benefits for all veterans whose compensable disabilities are unrelated to military service would create significantly larger savings.

An argument in support of this option is that benefits should be paid only to veterans whose disabilities are directly related to military service. An argument against this option is that veterans' compensation benefits are payments the federal government owes to veterans who become disabled in any way during a period of military service.

RELATED OPTIONS: 700-4 and 700-6

700-6—Mandatory

Reduce Veterans' Disability Compensation to Account for Social Security Disability Insurance Payments

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-1,687	-1,769	-1,840	-1,912	-1,989	-9,197	-20,458

Approximately 2.7 million veterans—about 1.9 million of them under age 65—receive compensation from the Department of Veterans Affairs (VA) for service-connected disabilities. The amount of compensation is based on a rating of an impairment's effect on a veteran's earnings capacity, on average, and disability ratings range from zero to 100 percent. Additional allowances are paid to veterans whose disabilities are rated 30 percent or higher and who have dependent spouses, children, or parents. Veterans with disabilities also may qualify for cash payments from other sources, including workers' compensation; private disability insurance; means-tested program benefits, such as Supplemental Security Income; and, for veterans under 65, Social Security's Disability Insurance (DI) program. About 132,000 veterans who receive disability compensation from VA also receive DI payments from the Social Security Administration. When Social Security beneficiaries are eligible for disability benefits from more than one source, ceilings usually limit combined disability benefits from public sources to 80 percent of a recipient's average predisability earnings. Those DI payments—after any applicable reduction—are adjusted periodically to reflect changes in the cost of living and in national average wages. Veterans' compensation payments for disabilities are not considered for that purpose, however, and thus do not apply toward limits. The same exclusion applies to means-tested benefits and to some benefits based on public employment.

This option would limit disability compensation for veterans who receive VA disability benefits and Social Security DI payments. Under the option, VA's disability compensation would be reduced by the amount of the DI benefit. Applying that change to current and future recipients of veterans' compensation would affect about 136,000 recipients in 2008, saving almost $1.7 billion that year and saving an estimated $9.2 billion between 2008 and 2012. Applying the change only to veterans who are newly awarded compensation payments or DI payments would affect some 2,700 recipients in 2008, saving $36 million in outlays that year and saving about $1 billion between 2008 and 2012.

A rationale for this option is that it would eliminate duplicate public compensation for a single disability. However, opponents view this option as subjecting veterans' disability benefits to a form of means-testing (VA benefits are considered entitlements). Moreover, to the extent that this option applied to current DI recipients, some disabled veterans would have their income reduced.

RELATED OPTIONS: 700-4 and 700-5

700-7—Mandatory

Increase and Index Withholding for the Montgomery GI Bill

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Outlays							
Increase withholding to $135 per month for 24 months	-42	-298	-330	-335	-339	-1,345	-3,040
Increase withholding and index future withholding for inflation	-42	-301	-342	-359	-375	-1,418	-3,448

The Montgomery GI Bill (MGIB) provides education benefits for most members of the armed services who joined after July 1985. Participating service members agree to have $100 per month withheld from their pay for 12 months after they begin active duty. The original MGIB benefit was $400 per month for 36 months of full-time education (or the part-time equivalent). Because of cost-of-living adjustments (COLAs) and legislative changes, that benefit has increased over the years and currently stands at $38,700 ($1,075 per month). The total amount withheld from a member's pay, however, has remained constant at $1,200. Because the withholding has not changed, the cost of the benefit to the service member has fallen every time the benefit has increased. The original 36 months of benefits came to $14,400, just over 8 percent of which was withheld from the service member's pay. The current maximum benefit is nearly three times as large, and the same $1,200 withheld equals just over 3 percent. To restore the original proportion of withholding to benefit, that amount would have to be increased to $3,225. At the current rate of $100 per month, reaching that total would take more than 20 additional months.

This option would increase the total withheld to $3,240 ($135 per month for 24 months). Because service members have participated in the program at a nearly constant rate despite changes in benefits, the Congressional Budget Office assumes that participation will remain relatively constant under this option. CBO estimates that if it was implemented, this option would decrease net direct spending by $42 million in 2008 and by $1.3 billion over five years. To sustain the original withholding-to-benefit ratio, this option also considers an annual increase, after 2008, in the proposed monthly withholding in the amount of a COLA that is equal to the amount applied to the benefit. The adjustment would have no effect on federal spending on MGIB benefits in 2008, but it would reduce spending by an additional $73 million over five years, resulting in total estimated savings of $1.4 billion over that period.

A rationale for this option is that if an 8 percent participant contribution was appropriate when the program began, it should be appropriate today. Otherwise, as benefits increase, the government assumes an increasing proportion of the cost of a veteran's education benefits. Increasing the amount withheld annually by the same COLA applied to the benefit would prevent the withholding-to-benefit ratio from shrinking again.

Arguments against this option could include the questionable nature of increasing the financial burden on service members during a time of war. Moreover, education costs have outpaced the MGIB benefit, so beneficiaries are already paying a larger proportion of their tuition. Increasing the number of months of withholding or raising the amount withheld would shift even more of the cost from the government to the individual service member.

750

Administration of Justice

The cost of administering federal law includes funding for the judicial branch, the Departments of Justice and Homeland Security, financial and tax crime enforcement activities within the Department of the Treasury, and the operation of other independent agencies, such as the Equal Employment Opportunity Commission, the Legal Services Corporation, and the U.S. Sentencing Commission.

Most spending in function 750 is discretionary, and it has increased over the past five years at an average annual rate of 4.5 percent. The limited mandatory spending in this function has averaged near $1 billion each year. The exceptional year was 2004, when some $6.4 billion in victim compensation payments was recorded as a result of the terrorist attacks of September 11, 2001. Spending for this function is projected to reach $45 billion in 2007, an increase of 8.9 percent over 2006.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	35.4	35.7	37.9	39.4	41.1	44.3	3.8	7.6
Outlays								
Discretionary	33.8	34.2	38.0	39.3	40.3	43.4	4.5	7.6
Mandatory	1.3	1.1	7.6	0.7	0.7	1.3	-13.4	84.1
Total	35.1	35.3	45.6	40.0	41.0	44.7	4.0	8.9

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

750-1—Discretionary

Reduce Funding for Certain Department of Justice Grants

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-603	-614	-626	-637	-648	-3,127	-6,553
Outlays	-113	-293	-428	-536	-628	-1,998	-5,316

In addition to the law enforcement activities that the Department of Justice (DOJ) carries out directly, it provides various types of assistance to nonprofit community organizations and state and local law enforcement agencies, mostly in the form of grants. DOJ provides such assistance through five programs, each of which is funded in a separate account in the federal budget: State and Local Law Enforcement Assistance; Justice Assistance; Juvenile Justice; Community Oriented Policing Services (COPS); and Violence Against Women.

The assistance provided through those programs will total nearly $2.4 billion in 2007, a figure that has declined by about 20 percent since 2004. This option would further reduce such financial assistance by 25 percent, saving $113 million in 2007 and about $2 billion over the 2008–2012 period.

Grants provided through the five programs are used for a wide array of activities, such as the purchase of body armor and other equipment for law enforcement officers and the improvement of DNA analysis and other forensic activities conducted by state and local police agencies. Other supported activities include substance abuse treatment programs for prisoners; Boys and Girls Clubs; research, development, and evaluation of state justice programs; and the collection and analysis of statistics and information on the judiciary.

Critics of federal spending for law enforcement assistance argue that DOJ directs much of its funding toward problems that are not federal responsibilities. According to figures published by the Bureau of Justice Statistics, in 2003, state and local governments spent a total of about $150 billion on criminal-justice activities, whereas the federal government spent just $30 billion on those activities. Instead, critics say, the federal government should concentrate on the funding of national security efforts.

Critics also argue that resources are used inefficiently and that financial assistance could be scaled back substantially with little impact on the nation's law enforcement capabilities. For example, a recent report by the Government Accountability Office found that grants awarded through the COPS program made only a modest contribution to declines in crime in the 1990s.[1]

Opponents of the option maintain that the federal government plays a vital role in augmenting the resources of the states and in directing funds to areas of critical national need. In certain cases, they argue, the problems those funds address are national in scope; without the incentive of federal grants, the states might neglect such problems because of the scarcity of their resources. Therefore, those advocates assert, such federal assistance helps make the nation safer.

1. Government Accountability Office, *Community Policing Grants,* GAO-06-104 (October 2005).

750-2—Discretionary

Eliminate the Legal Services Corporation

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-326	-339	-345	-352	-358	-1,720	-3,608
Outlays	-294	-338	-345	-351	-357	-1,685	-3,569

The Legal Services Corporation (LSC) was first authorized in 1974 as a private, nonprofit organization with authority to distribute grants to local entities that provide civil legal assistance to low-income clients. Today, the LSC awards competitive grants for one to three years to designated service areas covering the United States and its five territories. In 2006, the Congress appropriated a total of $327 million for the LSC.

Each year, the LSC's appropriations contain language restricting its use of funds for certain activities. Neither funds appropriated by the Congress, nor those otherwise generated, may be used for political activities, such as advocacy, strikes, or demonstrations; class-action lawsuits; client solicitation; or cases involving abortion, partisan redistricting, drug-related eviction, or welfare reform. Organizations receiving LSC funding also may not collect attorneys' fees or represent prisoners or illegal residents (except for victims of domestic or child abuse).

This option would terminate funding for the LSC beginning in 2008. That change would reduce discretionary outlays by $294 million in 2008 and by $1.7 billion over the next five years.

One rationale for eliminating funding for the LSC is that providing legal services to the poor is more properly a duty of state and local governments, which can be more responsive to local needs. In fact, programs receiving LSC grants already receive some resources from states, localities, and private entities, as well as from private attorneys involved in pro bono work. Moreover, critics of the program argue that, despite the restrictions already placed upon the LSC, the activities of legal-services lawyers too often focus on social causes rather than on meeting the needs of poorer people with routine legal problems.

Those in favor of continued support for the LSC argue that, despite funding from outside sources, contributions from the federal government represent over half of the funding for LSC grantees, on average, and remain the single largest and most important funding source for civil legal services nationally. LSC-funded programs resolve nearly 900,000 cases per year, over 60 percent of which involve family or housing law. Even so, LSC estimates that approximately half of those seeking legal assistance are turned away under current appropriated levels. Eliminating the LSC would remove a reliable source of funding for legal assistance for people with low incomes.

800

General Government

The general government function includes legislative and executive branch programs that support the basic responsibilities of the federal government. The programs in function 800 fit into three broad categories—revenue collection and financial management, general administration, and personnel operations—and can include assistance to state and local governments. The Internal Revenue Service accounts for the greatest share of spending (more than half of net outlays in 2006). Other large expenditures include payments for claims and judgments against the U.S. government, the General Services Administration's Federal Buildings Fund, and salaries and expenses for the Congress and legislative branch agencies.

The Congressional Budget Office estimates that total outlays for function 800 in 2007 will be nearly $19 billion—most of it discretionary spending. Over the past five years, spending for the function has increased at an average annual rate of just under 2 percent, although discretionary outlays have increased by about 3 percent a year. A large increase in mandatory spending in 2003 and 2004 was the result of $10 billion that the Congress provided in temporary fiscal assistance to states.

Federal Spending, Fiscal Years 2002 to 2007 (Billions of nominal dollars)

							Average Annual Rate of Growth (Percent)	
	2002	2003	2004	2005	2006	Estimate 2007[a]	2002-2006	2006-2007
Discretionary Budget Authority	15.1	17.1	16.9	15.9	16.7	16.1	2.6	-3.8
Outlays								
Discretionary	14.1	15.3	16.1	16.5	16.0	16.5	3.2	2.6
Mandatory	2.8	7.9	6.3	0.6	2.2	2.1	-6.4	-2.5
Total	17.0	23.2	22.3	17.0	18.2	18.6	1.8	2.0

a. Discretionary figures for 2007 stem from enacted appropriations for the Departments of Defense and Homeland Security and a full-year continuing resolution (P.L. 110-5) for other departments. Estimates for 2007 are preliminary and may differ from those published in the Congressional Budget Office's upcoming report *An Analysis of the President's Budgetary Proposals for Fiscal Year 2008*.

800-1—Discretionary

Eliminate General Fiscal Assistance to the District of Columbia

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-97	-97	-101	-102	-104	-501	-1,048
Outlays	-97	-97	-101	-102	-104	-501	-1,048

The Constitution gives the Congress responsibility for overseeing the District of Columbia—a task that the Congress largely delegated to the city's government under the Home Rule Act of 1974. However, the Congress reviews and approves the District's proposed annual budgets and appropriates money to the city each year. Under the National Capital Revitalization and Self-Government Improvement Act of 1997, the federal government reduced the annual payment of general assistance to the District. In exchange, the federal government agreed to fund the operations of the District's criminal justice, court, and correctional systems; assumed responsibility for paying off more than $5 billion in unfunded liabilities that the city owed to several pension plans; and provided special borrowing authority to the city. In 2007, federal assistance for those activities under the Revitalization Act makes up about 5 percent of the District's budget.

This option would eliminate fiscal assistance to the District that was not related to the specific obligations that the federal government assumed in the 1997 Revitalization Act. Such general assistance totals $95 million in 2007, including $33 million in tuition support for city residents; $26 million for school improvement, $14 million for scholarships to residents; $13 million for economic development; and $9 million for emergency planning and security. Ending such assistance would reduce federal outlays by $97 million in 2008 and by about $500 million over five years.

The rationale for this option is that the federal government already relieved the District government of the cost of a substantial, and increasing, portion of its budget, covering criminal justice, Medicaid, and pensions. The proposed trade-off for assuming responsibility for those functions was ending other assistance, including the annual federal payment. Eliminating general assistance would be consistent with that policy. Since passage of the Revitalization Act, the District has had 10 consecutive balanced budgets, including an operating budget surplus of $325 million in 2006. In line with those fiscal improvements, the District's bond ratings have risen, which reduces debt financing costs. Standard & Poor's, a leading credit-rating service, raised its rating of the District from B—a "junk bond" rating—in 1997 to A+ in 2005. Moreover, eliminating general assistance might give the District greater incentive to cut wasteful spending. Critics of the city's government contend that, with a budget of more than $7 billion in 2007, the District has the resources to provide a full range of services to its residents.

One argument against ending general federal assistance is that the District of Columbia has few alternative sources of revenue. The District is precluded by law from imposing commuter taxes on nonresidents who work in the city and benefit from its services, as many other cities do. (Two out of every three dollars earned in the District are earned by nonresidents.) In addition, more than 40 percent of city property—including property owned by the federal government or foreign nations—is exempt from local taxes. The District is also prevented from taxing income earned (but not property owned) by Fannie Mae, a government-sponsored enterprise based in the city, as part of a general prohibition on state and local taxation of the income of government-sponsored enterprises.

Another argument against this option is that the District still has major problems with its public schools, roads, drinking water, primary health care, and other essential services, such as ambulance services—suggesting a need for continuing financial assistance. In addition, eliminating federal funding for the city's tuition assistance program—which enables District residents to pay in-state tuition rates at public colleges nationwide or to receive up to $2,500 a year in financial aid at historically black colleges and universities—might undermine efforts to make the District more attractive to middle-class families. Further, in recent years, some federal assistance has been earmarked for charter schools and tuition vouchers, which has allowed the Congress to test those education approaches at the local level.

800-2—Mandatory

Require the IRS to Deposit Fees for Its Services in the Treasury as Miscellaneous Receipts

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Outlays	-107	-110	-112	-114	-116	-559	-1,168

The 1995 appropriation act for the Department of the Treasury and various agencies authorized the Internal Revenue Service (IRS) to establish or increase fees for some of the services that it provides. The IRS has used that authority mainly to charge taxpayers a fee for entering into payment plans with the agency. Under the 1995 law, the IRS can retain and spend the receipts collected from such fees. Previously, there had been a cap on the amount of funds the IRS was allowed to retain from fee receipts. However, the 2006 appropriation act for the Department of the Treasury and various agencies eliminated the cap. In 2006, the agency collected $100 million in fee receipts.

This option would require the IRS to deposit all of its fee receipts in the Treasury as miscellaneous receipts, eliminating the agency's ability to spend them. That change would reduce the IRS's direct spending by $107 million in 2008 and by $559 million through 2012 (assuming that the removal of spending authority did not substantially reduce the amount that the IRS collected in fees). However, those savings would be lost if the agency's annual appropriations—which total about $11 billion for 2007—were increased to make up for the lost fee receipts.

One rationale for this option is that processing payment plans for taxpayers is an administrative function directly related to the IRS's mission—getting citizens to pay the taxes they owe—and thus is a function for which the agency already receives appropriations. Another rationale is that the IRS does not directly use the receipts it collects from fees on installment agreements to pay for processing those agreements. Moreover, the current spending authority may give the agency an incentive to unnecessarily encourage taxpayers to pay their taxes in installments or to seek new and unnecessary fees.

One argument against this option is that continuing to allow the IRS to generate and use fee receipts may help ensure that the federal government's main revenue collector has sufficient funding to fulfill its mission. A decrease of over $100 million in annual funding might negatively affect its revenue-collecting capability. In addition, eliminating the spending authority could reduce the IRS's incentive to allow installment payments or its ability to provide for them, thus affecting taxpayers who would benefit from such arrangements.

800-3—Mandatory

Eliminate the Presidential Election Campaign Fund

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-50	-50	-50	-50	-50	-250	-500
Outlays	-200	-2	0	-35	-210	-447	-703

The Presidential Election Campaign Fund provides public funding for Presidential elections. It is financed exclusively by voluntary contributions from U.S. taxpayers, who can choose to earmark $3 ($6 on joint returns) of their annual federal income taxes for the fund. That money is used to provide matching funds for candidates in Presidential primaries, grants to sponsor political parties' Presidential nominating conventions, grants for the general-election campaigns of major party nominees, and partial funding for qualified minor- and new-party candidates in the general election. All recipients of public funds must agree not only to abide by limits on contributions and spending but also to comply with a Federal Election Commission audit and to make any necessary repayments to the Treasury.

This option would eliminate the fund, stopping the flow of public money to Presidential candidates and political parties. Savings from this option would total $200 million in 2008, a Presidential election year, and $447 million over the 2008–2012 period, which includes two Presidential elections.

Lawmakers devised the funding program in the early 1970s to correct problems that were thought to exist in the Presidential electoral process, such as the disproportionate influence (or the appearance of influence) of wealthy contributors; the demands of fund-raising, which prevented some candidates from adequately presenting their views to the public; and the rising cost of Presidential campaigns, which effectively disqualified candidates who did not have access to large sums of money.

Supporters of eliminating the Presidential Election Campaign Fund argue that candidates have found numerous indirect means of circumventing spending limits, such as having political parties or special-interest groups pay for "issue advertisements." They argue that the Presidential Election Campaign Fund does not deter fund-raising during the primaries because candidates either focus on soliciting the private donations necessary to qualify for matching public funds or rely solely on private donations to avoid the campaign spending limits imposed on those who receive public funding. Supporters of this option also dispute the need to give public funding either to major parties and candidates, which are already well financed, or to minor parties and candidates, which have little chance of success. Finally, the proportion of taxpayers who choose to earmark part of their taxes for the fund has declined steadily over the past three decades to only 10 percent in 2004, suggesting that the program has little public support.

Opponents of this option contend that public financing of Presidential elections limits the influence of special interests and wealthy contributors and allows poorly funded candidates to influence the national debate. They also argue that the money given to minor-party candidates (a small share of the total) allows such candidates to bring public attention to issues that might otherwise be ignored. Furthermore, opponents of eliminating the fund argue that taxpayer participation could be improved if the program's history and rationale—and the fact that participation does not increase a person's tax liability—were better publicized.

800-4—Discretionary

Eliminate the National Youth Anti-Drug Media Campaign

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget authority	-101	-103	-105	-106	-108	-523	-1,094
Outlays	-91	-102	-104	-106	-108	-512	-1,083

The National Youth Anti-Drug Media Campaign, administered by the Office of National Drug Control Policy, was established by the Congress in the Treasury and General Government Appropriations Act of 1998. The purpose of the campaign is to reduce and prevent drug abuse among young people in the United States. The majority of the campaign's funding goes to the purchase of advertising time or space in youth, adult, and ethnic media outlets, including national and local TV, radio, newspapers and other publications, the Internet, billboards, and cinema. The agency is required to solicit donations from nonfederal sources to pay part of the costs of the program. In addition, the program received appropriations of about $100 million for 2006.

This option would eliminate the National Youth Anti-Drug Media Campaign, saving $91 million in outlays in 2008 and $512 million over the 2008–2012 period.

Supporters of this option argue that there is no solid evidence that media campaigns are effective in either preventing or reducing the use of illegal drugs. A multiyear national evaluation of the campaign was completed in 2005 and found that the campaign did not reduce youth drug use nationally. Some analysts claim that media advertising does not reduce drug use among young people as effectively as treatment or interdiction does. Furthermore, because nonprofit organizations such as the Partnership for a Drug-Free America already conduct educational programs that illustrate the dangers of drug use, the campaign may duplicate private or local efforts.

Opponents of eliminating the program maintain that educating young people about the hazards of illegal drug use is a national responsibility. They argue that a national antidrug media campaign is needed to counter messages from mass media and popular culture that seem to promote drug use. Some point to surveys that have shown declines in teen drug use in recent years as evidence of the success of the campaign. They also argue that the cost to the nation of drug abuse is so high that it is worthwhile to maintain a program that reduces drug use even slightly.

920

Allowances

The President's budget and the Congressional budget resolution sometimes include amounts in function 920 that reflect proposals that are not clearly specified or that would affect multiple budget functions. Because funding is ultimately provided for specific purposes, the historical data show no budget authority or outlay totals for function 920. In this volume, that function includes options that cut across programs and agencies and that affect more than one budget function.

920-1—Discretionary

Raise the Threshold for Coverage Under the Davis-Bacon Act

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Spending							
Budget Authority	-115	-120	-125	-125	-125	-610	-1,290
Outlays	-45	-100	-135	-155	-160	-595	-1,470

Since 1935, the Davis-Bacon Act has required that workers on all federally funded or federally assisted construction projects whose contracts total $2,000 or more be paid no less than "prevailing wages" in the locality in which the project is located. The Department of Labor measures such wages on the basis of the wages and benefits earned by at least 50 percent of workers in a particular type of job or on the basis of the average wages and benefits paid to workers for that type of job.

Raising the threshold for determining which projects are covered by the Davis-Bacon Act from $2,000 to $1 million would save $45 million in discretionary outlays in 2008 and $595 million in the 2008–2012 period—provided that federal agencies' appropriations were lowered to reflect the anticipated reduction in costs.

A rationale for raising the threshold is that it has remained the same for more than seven decades and raising it would allow the federal government to spend less on construction, although the option's precise effect on contractors' costs is difficult to estimate. An argument against such a change is that it could lower the earnings of some construction workers and might jeopardize the quality of construction at federally funded or federally assisted work sites.

920-2—Discretionary and Mandatory

Reduce Benefits Under the Federal Employees' Compensation Act

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Reduce Benefits at Retirement Age							
Change in mandatory outlays	-15	-29	-30	-30	-31	-134	-296
Change in discretionary outlays	-7	-15	-37	-59	-82	-199	-965
Eliminate Augmented Benefits							
Change in mandatory outlays	-5	-9	-9	-10	-10	-42	-94
Change in discretionary outlays	-2	-5	-12	-19	-26	-63	-305

The Federal Employees' Compensation Act (FECA) program provides workers' compensation coverage to federal civilian employees. The program, which is administered by the Department of Labor, offers wage-replacement, medical, and vocational-rehabilitation benefits in the event of work-related injury or occupational disease. Federal employees who are injured on the job receive two-thirds of their lost pay if they have no dependents or "augmented benefits," equal to 75 percent of their lost pay, if they have at least one dependent. Those benefits continue throughout a worker's retirement years, even though FECA benefits substantially exceed a worker's retirement benefits in most instances. Roughly 140,000 FECA claims were filed in 2006; of those, 55,000 federal employees received long-term replacement benefits (averaging about $36,000) for a job-related injury, disease, or death. About three-fourths of those beneficiaries received augmented benefits. More than 60 percent of the beneficiaries were at least 55 years old.

This option would reduce FECA benefits in one of two ways. The first approach would give beneficiaries age 55 or older a separate FECA "annuity" equal to two-thirds of the benefit level they would have received under current law. The second approach would eliminate the additional benefits given to injured federal employees with at least one dependent. (The President has made similar proposals in his budgets for 2006 through 2008.) The two approaches are not mutually exclusive, but the effects of implementing them both would be less than the sum of the individual effects. In either case, the reduction in FECA benefits could yield savings not only through the effect on mandatory spending from the benefit account but also through possible reductions in appropriations for the agencies' salary and expense accounts (because most of the program costs are charged back to the beneficiaries' employing agencies).

Reducing FECA benefits after age 55 would yield mandatory savings of $15 million in 2008 and $134 million through 2012. The accompanying discretionary savings could be $7 million in 2008 and $199 million through 2012 (assuming appropriations are reduced). The second approach, eliminating augmented benefits, would save $5 million in 2008 and $42 million through 2012 in mandatory spending. And additional discretionary savings would be $2 million in 2008 and $63 million through 2012.

A rationale for the first approach is that, under the current benefit schedule, FECA provides what could be considered a windfall for permanently disabled employees who otherwise would be retired, indefinitely paying them benefits that are higher than those offered by their retirement plans. (By comparison, federal workers who retire under the Civil Service Retirement System at age 55 with 30 years of service receive benefits equal to 56 percent of their salary.) Moreover, permanently disabled employees covered by the Federal Employees Retirement System can cash out the defined-contribution portion of their retirement plans in addition to receiving FECA benefits. The higher benefits could encourage some employees to claim to be disabled in order to raise their retirement income. Giving injured retirement-age employees a separate FECA annuity equal to two-thirds of the current benefit level would better align the incentives to retire or return to work with those faced by noninjured employees and thus reduce the incentive to feign disability.

An argument against that approach, however, is that it would change a long-standing benefit, established by FECA in 1916, of compensation for workplace injuries. Moreover, injured workers who reached retirement age might have higher living expenses than their noninjured counterparts and thus need higher compensation. Further, reducing coverage would be unfair to employees who would have continued working past retirement age if they hadn't been disabled. (Fewer than 2 percent of federal civilian workers remain on the job after age 65, however.) Finally, the program's extensive review process has helped to exclude false claims.

The primary rationale for eliminating augmented FECA benefits for employees with dependents is that such benefits are out of line with those of other workers' compensation systems. Only six state systems authorize additional benefits for employees with at least one dependent, and those benefits are much smaller—about $5 to $10 per week in five states and $25 per week in the sixth, compared with 8.33 percent of the worker's previous salary in the case of FECA, or about $80 per week for an employee making $50,000 per year. Moreover, salaries and other employee benefits do not increase for workers with dependents.

An argument against eliminating augmented benefits is that they are necessary to compensate for any additional child care needs that arise because of an employee's injury.

RELATED OPTION: 150-1

920-3—Discretionary

Eliminate Cargo Preference

(Millions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Spending							
Budget authority	-356	-470	-589	-602	-616	-2,633	-5,940
Outlays	-295	-435	-553	-590	-609	-2,483	-5,761

The Cargo Preference Act of 1904 and other laws require that ships registered in the United States be used to carry certain government-owned or government-financed cargo that is shipped internationally. Traditional justifications for that "cargo preference" include maintaining the economic viability of the nation's maritime industry and bolstering national security by ensuring that U.S.-flag vessels and U.S. crews are available during wartime.

This option would eliminate cargo preference, allowing the government to ship cargo at the lowest available rates and thereby reduce federal transportation costs. Such action would save $295 million in outlays in 2008 and nearly $2.5 billion through 2012.

Two federal agencies, the Department of Defense (DoD) and the Department of Agriculture (USDA), account for most of the gross tonnage shipped under cargo-preference laws. The preference applies to nearly all of DoD's freight shipments and to three-quarters of USDA's shipments of food aid, as well as to shipments associated with programs sponsored by the Agency for International Development and the Export-Import Bank. Roughly 70 percent of the savings from eliminating cargo preference would come from defense discretionary spending, with the rest coming from nondefense discretionary spending.

One rationale for implementing this option is that cargo preference represents a subsidy of private vessels by taxpayers, which helps a handful of ship operators preserve their market share and market power. Another rationale is that cargo preference puts the U.S. government at a competitive disadvantage when selling surplus agricultural commodities abroad because the government must pay higher costs to transport those commodities.

A key argument against this option is that although DoD has invested in its own sealift fleet to transport military equipment and has contracted with foreign-flag ships when necessary, the department considers cargo preference an essential part of its sealift policy. ("Sealift" refers to the ocean transport of military cargo both in times of war and of peace. DoD's sealift policy is designed to ensure that sufficient military and civil maritime resources will be available to meet defense deployment and essential economic requirements in support of the United States' national security strategy.) Indeed, in deployments for the war in Iraq, DoD has made heavy use of U.S.-flag ships and has relied extensively on U.S. civilian mariners to crew its reserve ships. Another argument against the option is that cargo preference is necessary to offset federal requirements that raise labor costs and regulatory burdens and thus put the nation's maritime industry at a competitive disadvantage. (Under federal law, U.S.-flag ships must be crewed by U.S. mariners and, in general, must be built by U.S. shipyards.) Without guaranteed business from cargo preference, many U.S.-flag vessels might leave the fleet—by reflagging in a foreign country to save money or by decommissioning altogether. In addition, U.S. ship operators and shipbuilders might default on loans guaranteed by the government. (The estimated savings shown above do not reflect the possibility of such defaults.)

RELATED OPTION: 150-1

CHAPTER

3

Revenue Options

Option 1

Increase Individual Income Tax Rates

(Billions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Revenues							
Raise all tax rates on ordinary income by 1 percentage point	+21.1	+30.4	+30.3	+43.7	+50.8	+176.3	+445.2
Raise all ordinary tax rates and AMT rates by 1 percentage point	+38.1	+56.5	+59.9	+62.5	+66.0	+283.0	+667.8
Raise all ordinary tax rates, AMT rates, and dividend and capital gains rates by 1 percentage point	+38.8	+59.9	+62.6	+65.3	+67.2	+293.8	+685.6
Raise the top ordinary tax rate by 1 percentage point	+3.9	+5.5	+5.5	+6.4	+7.3	+28.6	+75.5
Raise the top two ordinary tax rates by 1 percentage point	+4.6	+6.6	+6.6	+8.6	+10.2	+36.6	+100.9
Raise the top three ordinary tax rates by 1 percentage point	+5.2	+7.5	+7.4	+10.6	+12.7	+43.4	+121.0
Raise the top four ordinary tax rates by 1 percentage point	+7.6	+11.0	+11.0	+18.7	+23.0	+71.3	+200.5
Raise the tax rate on ordinary taxable income over $1 million for joint filers ($500,000 for others) by 5 percentage points	+12.0	+17.0	+16.9	+19.0	+21.3	+86.2	+224.3

Source: Joint Committee on Taxation.

Note: AMT = alternative minimum tax.

Under current law, individuals will face six statutory rates on taxable income earned through tax year 2010: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, and 35 percent. After 2010, those tax rates are scheduled to revert to the five brackets—15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent—that were in effect before the Economic Growth and Tax Relief Reconciliation Act of 2001 was enacted.

Depending on his or her total taxable income, an individual may face several different rates (see the table on the next page). For example, in 2007, a person filing singly with taxable income of $35,000 would pay a tax rate of 10 percent on the first $7,825 of income, 15 percent on the next $24,025, and 25 percent on the last $3,150. The starting points for those tax brackets are indexed to increase with inflation each year.

Not all income that goes to individuals is taxed at those rates, however. Income from long-term capital gains (gains on assets that are held for more than one year) is subject to lower rates under a separate schedule. The same is true for income from dividends through 2010. Taxpayers subject to the alternative minimum tax (AMT)—another method of computing federal income tax liability—face statutory rates of 26 percent and 28 percent.

This option would increase statutory rates under the individual income tax in several alternative ways:

- Raise all tax rates on ordinary income by 1 percentage point.

- Raise all ordinary tax rates and the rates of the AMT by 1 percentage point.
- Raise all ordinary tax rates, the AMT rates, and the separate rates on dividends and capital gains by 1 percentage point.
- Raise either the top one, top two, top three, or top four tax rates on ordinary income by 1 percentage point.
- Raise by 5 percentage points the rate on ordinary taxable income above $1 million for married couples filing jointly and above $500,000 for other taxpayers.

Boosting all statutory tax rates on ordinary income by 1 percentage point would increase revenues by a total of $176.3 billion over the five-year period from 2008 to 2012. Under that alternative, for example, the top rate of 35 percent in 2010 would rise to 36 percent, and the top rate of 39.6 percent thereafter would increase to 40.6 percent. Rates for the AMT would remain the same as under current law. Thus, the revenue impact of raising all of the ordinary tax rates would diminish over time as more taxpayers became subject to the AMT and therefore were not affected by the rise in regular rates.

Raising AMT rates as well as all of the regular tax rates by 1 percentage point would increase revenues during the 2008–2012 period by $283.0 billion. That revenue impact would be less affected by the number of taxpayers subject to the AMT because such taxpayers would face higher statutory tax rates, too. If, *in addition to raising the ordinary and AMT rates, lawmakers boosted the separate tax rates on capital gains and dividends by 1 percentage point*, federal revenues would increase by a total of $293.8 billion over the next five years.

Alternatively, lawmakers could target specific individual income tax rates. For example, *boosting only the top statutory rate on ordinary income by 1 percentage point* would raise $28.6 billion over the 2008–2012 period. Most people who face the top rate in the ordinary rate schedule are not subject to the alternative minimum tax, so the AMT would not limit the impact of that increase in regular tax rates.

A final alternative would be to create an additional bracket at the top of the regular rate schedule by *raising the tax rate on ordinary taxable income in excess of $1 million for joint filers ($500,000 for other taxpayers) by 5 percentage points*. Income above those levels would be taxed at a rate of 40 percent through 2010 and 44.6 percent thereafter, which would increase revenues by $86.2 billion over five years.

As a way to raise revenues, a boost in tax rates would have some administrative advantages over other types of tax increases because it would require only relatively minor changes to the current tax-collection system. Rate hikes would also have drawbacks, however. Higher tax rates would reduce people's incentives to work and save. In addition, they would encourage taxpayers to shift income from taxable to nontaxable forms and to increase spending on items that are tax-deductible, such as home mortgage interest and charitable donations. In those ways, higher tax rates would cause economic resources to be allocated less efficiently than they might be otherwise.

The estimates shown here incorporate the assumption that taxpayers would respond to higher rates by shifting income from taxable to nontaxable or tax-deferred forms. (Such a shift might involve substituting tax-exempt

Starting Point for Tax Rate Bracket (2007 dollars)		Statutory Tax Rate on Ordinary Taxable Income (Percent)	
Single Filers	Joint Filers	2007-2010	After 2010
0	0	10	15
7,825	15,650	15	15
31,850	63,700	25	28
77,100	128,500	28	31
160,850	195,850	33	36
349,700	349,700	35	39.6

bonds for other investments or opting for more tax-free fringe benefits instead of cash compensation.) However, the estimates do not incorporate potential changes in how much people would work or save in response to higher statutory tax rates. Such changes are uncertain and would depend in part on whether the federal government used the added tax revenues to pay down debt or to finance tax cuts or additional spending.

RELATED OPTIONS: Revenue Options 2, 3, 4, and 5

RELATED CBO PUBLICATIONS: *Historical Effective Federal Tax Rates: 1979 to 2004,* December 2006; *Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates,* December 1, 2005; *The Alternative Minimum Tax,* April 15, 2004; and *How CBO Analyzed the Macroeconomic Effects of the President's Budget,* July 2003

Option 2

Permanently Extend the Individual Income Tax Provisions of EGTRRA

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues[a]	-0.5	-2.3	-2.4	-97.8	-174.7	-277.7	-1,221.9

Source: Joint Committee on Taxation.

a. These estimates represent the change in the overall budget balance resulting from the sum of changes to both revenues and outlays.

In the past six years, the Congress and the President have enacted several tax laws that substantially alter the individual income tax system: the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the Working Families Tax Relief Act of 2004 (WFTRA), and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). EGTRRA reduced tax rates, created a 10 percent tax bracket, increased the value of the child tax credit, provided relief from the marriage penalty and the alternative minimum tax (AMT), and made many smaller changes to the tax code. The main provisions of EGTRRA were originally scheduled to phase in gradually between 2001 and 2010; the entire law was slated to expire in 2011. JGTRRA accelerated the phasing in of some of those provisions. It also further lessened the burden of the AMT and reduced the tax rate on income from capital gains and certain dividends. WFTRA extended several of the provisions that had been accelerated under JGTRRA—the larger child tax credit, marriage-penalty and AMT relief, and the 10 percent tax bracket—for various lengths of time. TIPRA extended the reduced rates on capital gains and dividend income through 2010 and provided relief from the AMT in 2006. Finally, the Pension Protection Act of 2006 permanently extended the provisions of EGTRRA that deal with retirement savings.

This option would make permanent nearly all of those changes to the individual income tax, including AMT relief. (The exception would be the reduced tax rates on capital gains and dividends, which are discussed in the next option.) Provisions of EGTRRA that are set to expire in 2011 would instead continue at the levels specified for 2010; provisions that are due to expire earlier would remain at the level specified for the final year before they would otherwise have reverted to the 2001 level. Provisions that were accelerated or expanded by JGTRRA, WFTRA, or TIPRA would continue at the fully phased-in level. Together, those changes would reduce revenues and increase outlays by a total of $277.7 billion over the 2008–2012 period.

Extending those provisions would have various effects on how efficiently the economy functions, with the effects depending in part on how the extensions were financed. One important channel for those economic effects is through the lower marginal tax rates (the rate that applies to a taxpayer's last dollar of income) that would be associated with extending the provisions. Higher marginal tax rates distort various decisions—for example, by encouraging people to shift income from taxable to nontaxable forms (which could be accomplished by substituting tax-exempt bonds for other investments or tax-free fringe benefits for cash compensation). Higher rates also motivate people to spend more on tax-deductible items, such as home mortgage interest and charitable donations. Lower tax rates can reduce those distortions and allow investment to be allocated to whatever use has the highest economic return, thus leaving people better off. Lower marginal tax rates can also encourage people to work and save more (unlike lower *average* tax rates, which can encourage people to work and save less).

The broader economic impact of lower tax rates, however, depends on how the rate reductions are financed. Financing tax cuts through higher budget deficits would reduce national saving, which would impair long-term economic growth and could offset any positive economic effects of the lower tax rates.

Permanently extending EGTRRA's individual income tax provisions would have mixed effects on the complexity of the tax system, which some people advocate simplifying. Certain provisions, such as relief from the AMT, simplify the tax code for some taxpayers. Other provisions, such as the expansion of tax-favored accounts for education savings, complicate the tax code.

Besides effects on economic efficiency and the complexity of the tax code, equity (fairness) is another key consideration in assessing tax policy. EGTRRA's individual income tax provisions reduce income taxes by a larger share of previous after-tax income for higher-income households than for lower-income households. However, although the reductions relative to income would be greater for higher-income households, extending EGTRRA's provisions would not significantly alter the shares of income taxes paid by different households across the income distribution.

RELATED OPTIONS: Revenue Options 1, 3, and 42

Option 3

Permanently Extend the Zero and 15 Percent Tax Rates for Capital Gains and Dividends

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.4	+1.4	-1.6	-13.9	-17.7	-31.4	-208.5

Source: Joint Committee on Taxation.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) reduced the special tax rates that apply to most long-term capital gains (gains on assets that are held for more than a year). The rate at which those gains are taxed depends on the income of the individual who realizes them. Gains realized by people whose income puts them in the top four tax brackets for ordinary income (25 percent, 28 percent, 33 percent, or 35 percent) are now taxed at a 15 percent rate, compared with 20 percent before JGTRRA. Gains realized by people whose income puts them in the two lowest brackets (10 percent or 15 percent) are taxed at a 5 percent rate, down from the pre-JGTRRA rate of 8 percent or 10 percent. In a major change, JGTRRA also extended the new 5 percent and 15 percent tax rates on capital gains to dividends from U.S. and some foreign corporations. (Dividends had previously been taxed at the higher rates on ordinary income.)

JGTRRA's rates on capital gains and dividends had been scheduled to last through 2008, with the 5 percent rate falling to zero that year. However, the Tax Increase Prevention and Reconciliation Act of 2005 extended the zero and 15 percent rates through 2010. Starting in 2011, rates on capital gains are scheduled to revert to 10 percent or 20 percent for gains held up to five years and to 8 percent or 18 percent for many gains held longer than five years. Tax rates on dividends are scheduled to return to the rates on ordinary income, which would range from 15 percent to 39.6 percent at that point.

This option would permanently extend the zero and 15 percent tax rates on capital gains and dividends. Such a change would reduce revenues by $31.4 billion over the 2008–2012 period and by $208.5 billion over the 2008–2017 period. The reduction in revenues over 10 years would be much greater than the drop during the first five years because the option would not affect current-law tax rates until January 1, 2011.

The main rationale for lower tax rates on capital gains and dividends is that they reduce the extra tax burden that the law previously placed on equity invested in C corporations (companies subject to the corporate income tax). Most large businesses and some small ones are organized as C corporations. The return on the equity invested in such companies is corporate profits. Once a firm has paid corporate income tax (typically 35 percent) on those profits, it can either distribute the remaining profits to shareholders as dividends, which are then taxed at the individual level, or it can retain and reinvest them. Reinvested earnings presumably increase a corporation's value (by roughly the amount invested), so they also raise the value of the firm's stock. When individuals sell that stock, they pay capital gains taxes on the reinvested earnings. Thus, the return on equity invested in C corporations is often taxed twice: once as corporate profits and a second time as dividends or capital gains. By reducing tax rates on the latter types of income, current law lessens—but does not eliminate—the extra tax burden.

Those extra taxes on corporate profits distort investment to some degree. They prompt some investment to be shifted from C corporations to other types of businesses—such as S corporations, partnerships, sole proprietorships, or limited liability companies—and to owner-occupied housing. The additional taxes also encourage C corporations to finance more of their investments by selling bonds rather than stock (because corporations can deduct interest payments on bonds) and by retaining earnings rather than paying dividends (because individuals normally pay lower tax rates on capital gains and can defer realizing the gains). Those distortions interfere with the allocation of investment to whatever use has the highest economic return. Consequently, they reduce economic efficiency and leave most people less well off.

Current law mitigates those distortions by lessening the extra tax burden—but only for a short period. Because

the lower rates on dividends and capital gains expire at the end of 2010, investments made after that time will not benefit from them. In addition, many investments made between 2003 and 2010 will benefit only partially from the lower tax rates because some of the returns will not be earned until after 2010. Hence, many of the gains in economic efficiency that could result from the lower rates will not be realized unless current law is perceived to be permanent.

Other options for reducing the extra tax burden on corporate equity have been widely discussed. Under one alternative, dividends and capital gains paid from profits that had been fully taxed at the corporate level would themselves be exempt from taxation at the individual level (see Revenue Option 25). Another approach would end the practice of allowing firms to deduct interest costs from their taxable income and would tax other types of businesses at the same rate as C corporations.

Compared with those other options, the lower rates provided under current law are less complete and less targeted, though simpler. They remove less of the extra burden from the return on corporate equity than those alternatives would. They also apply more broadly because they are not limited to dividends and gains from fully taxed corporate profits. Corporations (like individuals) receive extra tax deductions and credits for certain investments; thus, the return on those investments is less burdened under current law than is the return on fully taxed profits. Furthermore, people realize capital gains from investments in unincorporated businesses and individually owned property, and neither type of investment is subject to the tax on corporate profits. Such imprecise targeting reduces the effectiveness of current tax rates on capital gains and dividends because it fails to lessen the burden on fully taxed corporate earnings relative to all other returns on investments. Complete and targeted leveling of the tax burden would be more complicated to administer, and policymakers in the United States have never tried it. Targeting could be improved, however, with little additional complication by limiting the lower capital gains tax rates to gains on shares of C corporations.

The main argument against extending the lower tax rates on dividends is that the previous rates that applied to dividends may not have distorted the allocation of investment. Some analysts believe that the tax on dividends affects returns to stock owners but not corporations' decisions to invest. In that view, reducing the tax rate on dividends to no more than 15 percent provided a windfall to shareholders. Economists are currently investigating the degree to which the tax on dividends distorts investment. (Most analysts agree, however, that the tax on capital gains distorts investment decisions by C corporations, so the rationale for taxing capital gains on corporate stocks at a lower rate is not subject to the same question.)

The taxation of capital gains is one of the more complex parts of the individual income tax. Permanently extending the zero and 15 percent tax rates would reduce some of the complexity present under current law. It would preserve other sources of complexity, however, such as the rules that are needed to limit taxpayers' ability to convert ordinary income into capital gains and the different tax rates that apply to gains from the sale of specific types of assets. (Greater simplicity is discussed in the next option.)

RELATED OPTIONS: Revenue Options 4 and 25

RELATED CBO PUBLICATION: *Capital Gains Taxes and Federal Revenues,* October 9, 2002

Option 4

Replace Multiple Tax Rates on Long-Term Capital Gains with a Deduction of 45 Percent of Net Realized Gains

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.1	+5.1	+4.6	+3.9	+1.2	+13.5	+8.4

Source: Joint Committee on Taxation.

When a taxpayer sells an asset whose value has increased since it was purchased, the taxpayer realizes a capital gain, which is generally subject to taxation. Gains realized on assets that are held for more than a year (long-term capital gains) are taxed at various rates, many of which are lower than the rates that apply to ordinary income. Which tax rate a capital gain is subject to depends on the year in which the gain is realized, the type of asset sold, how long it was held, and the taxpayer's other income—a level of complexity that requires people to make numerous calculations to determine their tax liability.

This option would simplify that process by allowing taxpayers to deduct from their taxable income 45 percent of their net realizations of long-term capital gains—whether or not they itemize their other deductions. The remaining 55 percent of their gains would be taxed as ordinary income. With the deduction, a taxpayer's actual rate on capital gains would be 55 percent of his or her marginal rate on ordinary income (the rate on the last dollar of income). In 2008, for example, someone in the 25 percent tax bracket for ordinary income would face a rate of 13.75 percent on capital gains; someone in the 35 percent bracket would face a rate of 19.25 percent. (Taxpayers subject to the alternative minimum tax would adjust for its lower rate structure by treating 31 percent of the deduction as income taxable under the alternative tax.) This option is a variant of the exclusion that applied to capital gains before 1987.

Those changes are designed to be roughly revenue neutral over the 2008–2017 period, under the assumption that they would be enacted at the end of 2007 and take effect on January 1, 2008. Under current law, tax rates on capital gains are scheduled to rise abruptly at the beginning of 2011; relative to current law, this option would increase revenues by a total of $13.5 billion over the next five years (in an irregular pattern) but would reduce revenues by a total of $5.1 billion over the following five years.

The tax rates that apply to capital gains under current law are highly varied and complex. For example, through 2010, taxpayers who are in individual income tax brackets of 25 percent or above and who sell corporate stock owned for more than a year will pay 15 percent in taxes on their realized gains. Starting in 2011, however, they will pay 20 percent—unless the stock was purchased in 2001 or later and held for at least five years. In that case, the applicable rate will be 18 percent. Taxpayers in the 10 percent or 15 percent bracket of the individual income tax face a 5 percent rate on gains through 2007 and then no tax on capital gains through 2010. Beginning in 2011, those taxpayers will face rates of 10 percent on gains from assets held for up to five years and 8 percent on gains from assets held for more than five years. An exception to all of those rates exists for original stock from certain start-up businesses that is held for more than five years. Gains from such stock are generally taxed at an effective rate that is half of the taxpayer's rate on ordinary income, up to a maximum of 14 percent. Through 2010, that maximum alternative rate turns out to be similar to the top rate of 15 percent on gains from other types of stock.

Gains on many other assets face the same rates as gains on corporate stock, but there are exceptions. Some unrecaptured depreciation on real estate is classified as a capital gain and taxed at ordinary income tax rates, up to a maximum of 25 percent. Gains from the sale of gold, art, or other collectibles are also taxed at ordinary rates, but up to a maximum of 28 percent. Taxpayers who are subject to the alternative minimum tax face different rates on gains from selling collectibles or original stock issues of certain start-up companies.

The variety of rates forces taxpayers with long-term gains to make many calculations to determine their tax. On their 2006 returns, for example, taxpayers with gains from most sales of assets or with qualifying dividends

must figure their tax by completing a worksheet with 19 lines. If a taxpayer has a gain on a qualifying start-up business or a collectible, he or she must instead complete a worksheet with 7 lines and then another with 37 lines. For a gain on depreciated real estate, worksheets with 18 and then 37 lines are required. Beginning in 2011, the forms will become even more complicated because different rates will be applied to most gains on assets held for at least five years.

The main advantage of this option is that it would substantially lessen the burden of complying with the capital gains tax by replacing the current worksheets with just three or four lines on the schedule for reporting capital gains. The new calculation would be similar to the calculations required between 1942 and 1986, when the tax code excluded a portion of capital gains from taxpayers' adjusted gross income. Unlike that exclusion, however, this approach would not understate the income of taxpayers with gains when determining eligibility for tax credits and other advantages intended for lower-income people.

The main disadvantage of this option is that it would overturn several provisions of the tax code that policymakers, for various reasons, have decided are desirable. In particular, the option would eliminate separate capital gains rates for assets that are classified as collectibles or held for more than five years (whether issued by a start-up business or not). Furthermore, all deductions for depreciation would be recaptured at ordinary tax rates instead of some depreciation benefiting from rates that are capped at 25 percent. Care is warranted, therefore, in weighing the reasons for those provisions against the benefits of simplification.

In 2003, tax rates on dividends were reduced to equal the rates on capital gains in order to offset some of the extra burden that dividends and capital gains on corporate stock bear because of the corporate income tax (see the previous option). Under current law, that parallel treatment will continue through 2010. Parallel treatment could be retained in this option by extending the same 45 percent deduction to qualifying dividends. A further step to reflect the unique tax burden on corporate stock would be to allow the deduction only for dividends and gains on corporate stock and to tax gains on other assets as ordinary income. (Revenue Option 25 addresses the integration of corporate and individual income taxes more completely.)

RELATED OPTIONS: Revenue Options 1, 3, and 25

RELATED CBO PUBLICATION: *Capital Gains Taxes and Federal Revenues,* October 9, 2002

Option 5

Provide Relief from the Individual Alternative Minimum Tax

(Billions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Revenues							
Make the current exemption amounts permanent and index the AMT for inflation	-21.3	-57.3	-67.3	-56.7	-34.0	-236.6	-522.5
Apply some regular deductions and exemptions to the AMT	-29.6	-78.7	-91.5	-74.9	-39.1	-313.8	-627.2
Eliminate the AMT	-34.1	-88.6	-100.1	-81.1	-40.6	-344.5	-668.1

Source: Joint Committee on Taxation.

Note: AMT = alternative minimum tax.

As its name implies, the individual alternative minimum tax (AMT) is an alternate method of computing federal income tax liability. A minimum tax was initially enacted in 1969 amid concerns that taxpayers with substantial income were aggressively using tax preferences to reduce their tax liability to very low levels—in some cases, to zero. The Tax Reform Act of 1986 largely established the present form of the AMT; policymakers have modified the tax several times since that law was enacted.

In recent years, the AMT has begun to affect growing numbers of taxpayers. As a result, lawmakers have enacted a series of temporary measures to reduce the number of people subject to the tax. This option would either make some of those measures permanent, make further changes to limit the scope of the AMT, or do away with the minimum tax entirely. Those alternatives would reduce federal revenues by as much as $34.1 billion in 2008 and $344.5 billion over five years.

To compute liability under the AMT, taxpayers must include several additional items in their taxable income that are excluded under the regular income tax, such as the deduction for state and local taxes, personal exemptions, and the standard deduction. The additional items also include tax preferences that only taxpayers with complex financial circumstances generally use: for example, the deduction for some intangible costs associated with drilling for oil and gas. Under the AMT, the total of those adjustments is replaced with an exemption—in tax year 2006, $42,500 for single filers and $62,550 for married couples filing a joint return—that phases out at higher income levels. Taxpayers subtract the exemption from their income to determine their alternative minimum taxable income, which is taxed at two rates: 26 percent on the first $175,000 and 28 percent on the remainder. Taxpayers must pay the higher of their liability under the AMT or under the individual income tax.

The size of the AMT exemptions was temporarily increased by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), the Working Families Tax Relief Act of 2004 (WFTRA), and the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). Before 2001, the exemptions were $33,750 for single filers and $45,000 for joint filers. EGTRRA raised those amounts to $35,750 for single filers and $49,000 for joint filers for tax years 2001 and 2002. JGTRRA increased the exemptions further—to $40,250 and $58,000 for both 2003 and 2004—and WFTRA extended those amounts through 2005. TIPRA raised the exemptions to $42,500 and $62,550 for 2006. Under current law, the exemptions revert to their pre-EGTRRA levels beginning in 2007.

Unlike the tax brackets and exemptions for the individual income tax, the brackets and exemptions for the AMT are not indexed to increase with inflation each year. At any given level of nominal income, taxpayers will see their liability under the individual income tax decline over time as the value of the standard deduction and personal exemptions rises with inflation. Moreover, as the size of the lower tax brackets grows, more income is taxed at lower rates. With the AMT, by contrast, the lack of indexation means that liability at a given level of nominal

income remains the same. Therefore, as nominal income grows with inflation over time, AMT liability will exceed liability under the individual income tax over a larger and larger portion of the income distribution, shifting increasing numbers of taxpayers to the AMT from the individual income tax.

Policymakers could reduce the number of taxpayers subject to the AMT in several alternative ways. One approach would be to make the exemption amounts enacted in TIPRA permanent and to index both them and the AMT brackets for inflation after 2007. Under that approach, 6.2 million taxpayers would be affected by the AMT in 2010 (the peak year)—rather than 30 million under current law—and revenues would be $236.6 billion lower over the 2008–2012 period than they would be otherwise.[1] A second alternative would be to allow taxpayers to take the standard deduction, personal exemptions, and deduction for state and local taxes when computing their tax liability under the AMT. That change would reduce the number of people affected by the AMT to 2.8 million in 2010 and cut revenues by $313.8 billion over the 2008–2012 period. A third alternative, which was included in the 2005 report of the President's Advisory Panel on Federal Tax Reform, would be to eliminate the AMT altogether. That alternative would move the estimated 30 million taxpayers who would have been subject to the AMT in 2010 back to the individual income tax, at a revenue cost of $344.5 billion over five years.

A major benefit of all three of those approaches would be simplification. Taxpayers who are now affected by the AMT or who are close to being affected by it must calculate their tax liability twice. As the number of such taxpayers rises sharply, the complexity of many tax returns will increase. Many taxpayers will join the AMT's ranks not because they are sheltering a large amount of income but because they have many dependents or high state and local taxes. This option would simplify the tax system by making fewer taxpayers subject to the alternative tax.

Another rationale for providing relief from the AMT would be to mitigate the perhaps unintended consequences that an unindexed AMT would have on certain features of the tax system. For example, if the AMT is not modified, it will begin to limit the value of the standard deduction and personal exemption under the regular income tax. That process alone will make some taxpayers subject to the AMT, beyond those whom the tax was originally intended to target, and will increase their tax liability over time.

Potential disadvantages of providing relief from the AMT, besides the large reduction in revenues, involve issues of fairness and economic effects. First, the approaches in this option would primarily benefit higher-income taxpayers. Second, the changes would affect people's incentives to work and save. Relief from the AMT would alter the marginal tax rate (the rate that applies to the last dollar of income) faced by taxpayers who are currently subject to the alternative tax. Some taxpayers would see their marginal rates increase under these alternatives, although more would see their marginal rates decline. AMT relief might reduce some people's tax liability, which would allow them to achieve the same level of after-tax income with less income before taxes and thus, to some extent, affect their work behavior. On balance, how the changes in this option would affect incentives to work and save is not clear; the overall impact would depend on taxpayers' relative responsiveness to those incentives.

1. That alternative is similar to one discussed in CBO's *The Budget and Economic Outlook: Fiscal Years 2008 to 2017* (January 2007), Table 1-5. The revenue estimates differ, however, because they are based on different baseline projections of federal revenues.

RELATED OPTION: Revenue Option 2

RELATED CBO PUBLICATIONS: *The Budget and Economic Outlook: Fiscal Years 2008 to 2017,* January 2007, Table 1-5 and Box 4-2; *Testimony on the Individual Alternative Minimum Tax,* May 23, 2005; and *The Alternative Minimum Tax,* April 15, 2004

Option 6

Use an Alternative Measure of Inflation to Index Tax Parameters

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues[a]	+0.4	+2.1	+2.5	+5.5	+7.9	+18.4	+81.8

Source: Joint Committee on Taxation.

a. These estimates represent the change in the overall budget balance resulting from the sum of changes to revenues and to outlays for the refundable portion of the earned income tax credit.

Various parameters of the tax code are indexed to increase at the rate of inflation each year, as measured by the consumer price index for all urban consumers (CPI-U). Those parameters include the amounts of personal and dependent exemptions, the size of the standard deductions, the income thresholds that divide the different rate brackets in the individual income tax, the amount of annual gifts exempt from the gift tax, and the thresholds and phaseout boundaries for the earned income tax credit, the child tax credit, and several other, minor credits. Indexing allows those tax parameters to grow over time in nominal terms but keeps them relatively stable in real (inflation-adjusted) terms.

This option would use the chained CPI-U, an alternative measure of inflation, rather than the standard CPI-U to index parameters of the tax code. Both measures are calculated by the Bureau of Labor Statistics; however, the Congressional Budget Office estimates that the chained CPI-U is likely to grow 0.3 percentage points more slowly than the standard CPI-U. Indexing with that lower measure would increase the amount of income subject to taxation over time and thus result in higher tax revenues. The net revenue increase would be relatively small in 2008 (about $400 million) but would grow in subsequent years, reaching $7.9 billion in 2012 and totaling $18.4 billion over that five-year period. (Using the same alternative measure for all federal benefit programs that are indexed for inflation would reduce spending by $34.5 billion over the five-year period and by nearly $140 billion through 2017.)

A rationale for indexing tax parameters by less than the full increase in the CPI-U is that many analysts believe the CPI-U overestimates changes in the cost of living. The CPI-U measures inflation on the basis of price changes for a fixed basket of goods. According to many analysts, that method fails to fully account for increases in the quality of existing products, the value of newly introduced products, and the extent to which households can maintain their standard of living by substituting one product for another when the price of a good changes relative to the prices of all other goods. To explicitly address the substitution bias inherent in the CPI-U, the Bureau of Labor Statistics created the chained CPI-U.

Using the chained CPI-U to index tax parameters would be difficult to implement, however, because that measure is subject to revisions. In addition, because indexing with that lower measure would raise the amount of taxable income and thus tax revenues over time, it would result in an increased burden on taxpayers.

RELATED OPTIONS: 600-3 and 650-1

Option 7

Reduce the Mortgage Interest Deduction or Replace It with a Tax Credit

(Billions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Revenues							
Reduce the maximum mortgage on which interest can be deducted from $1 million to $400,000	+4.2	+4.9	+5.7	+7.2	+8.3	+30.3	+88.1
Convert the mortgage interest deduction into a credit	+21.7	+31.2	+34.2	+37.8	+41.0	+165.9	+418.5

Source: Joint Committee on Taxation.

The tax code treats investments in owner-occupied housing more favorably than other investments. For example, if a person owns a house and rents it out, he or she pays taxes on the rental income (net of expenses such as mortgage interest, property taxes, depreciation, and maintenance). The owner also pays a tax on any capital gain when the house is sold. If, instead, the owner lives in the house, no rent changes hands, so the tax code does not require the owner to report the rental value of the home as gross income. Yet the owner can deduct mortgage interest and property taxes from his or her other income in computing income tax liability. The owner can also exclude from taxation as much as $250,000 of any capital gain (or $500,000 if filing a joint return) when the home is sold.

In part, the rental value of housing services is excluded from income because it is difficult to determine that value when no rent changes hands. It is simple, however, to exclude expenses in calculating taxable income. In fact, housing-related expenses other than mortgage interest and property taxes cannot be deducted from a homeowner's income. Moreover, current law limits the amount of mortgage interest that can be deducted to the interest on up to $1 million of debt that a homeowner has incurred to buy, build, or improve a first or second home, as well as interest on as much as $100,000 in other loans (such as home-equity loans) that the owner has secured with the home, regardless of the loans' purposes.

This option would further restrict the mortgage interest deduction in one of two ways. The first alternative would lower the maximum mortgage amount eligible for the interest deduction from $1 million to $400,000. That change would raise taxes for 1.2 million people with large mortgages in 2008, increasing revenues by $4.2 billion in that year and by $30.3 billion over the 2008–2012 period. The lower cap would affect more homeowners over time as incomes and housing prices rose.

The second alternative would replace the current deduction with a 15 percent tax credit for interest on mortgages of $400,000 or less on a primary residence only. (In 2005, the President's Advisory Panel on Federal Tax Reform proposed a more complex variant of that approach.) That alternative would increase taxes for an estimated 28.6 million people in 2008 but lower them for some other taxpayers. In all, the change would increase revenues by $21.7 billion in 2008 and by $165.9 billion over five years because the reduced benefits to taxpayers in higher rate brackets would exceed the increased benefits to taxpayers in lower brackets.

The main rationale for curtailing the mortgage interest deduction is to improve the efficiency of the economy. The deduction encourages people to invest more in owner-occupied housing than they would if all investments were taxed equally. As a result, the owner's return on additional investment in housing, aside from the tax advantages, is likely to be lower than returns on additional investment in businesses. Reducing the maximum mortgage on which interest could be deducted should make affected homeowners less willing to invest in homes relative to stocks, bonds, savings accounts, and their own businesses. Between 1981 and 2005, 37 percent of net private investment in the United States went into owner-occupied housing. That share is large enough that less investment in owner-occupied housing—even for larger homes alone—could eventually boost capital in other sectors of the economy and increase total economic output.

Another advantage of limiting the mortgage interest deduction is that it would discourage taxpayers from borrowing against their homes to fund tax-favored retirement savings accounts, such as 401(k) plans and individual retirement accounts. That practice takes advantage of tax savings on both transactions and thus provides an incentive for people to pay down their mortgage debt more slowly and contribute more to retirement accounts than they would if mortgage interest were not deductible. Such transactions reduce revenue without increasing net saving, because the higher retirement contributions are offset by larger amounts of outstanding mortgage debt.

A drawback of limiting the deductibility of mortgage interest suddenly and deeply is that home values, home construction, and mortgage lending would most likely fall abruptly, particularly for larger houses. Those rapid declines would create hardships for owners of such homes, for builders, and for lenders. Lowering the cap gradually, or with substantial advance warning, would greatly reduce the hardships of adjusting to the change. Nonetheless, over the long run, the shift of investment from housing to other activities would mean less home construction and less increase in the value of homes than would occur under current law.

Another drawback is that this option might reduce home ownership. Greater home ownership contributes to social and political stability, according to its advocates, by strengthening people's stake in their communities and governments. In addition, home ownership motivates people to maintain their homes and may bolster neighborhoods by reducing mobility. Individuals typically do not consider those benefits to the community when deciding whether to rent or own, so a subsidy to promote home ownership may tilt their decisions in the direction of the community's interest.

The mortgage interest deduction, however, may be an ineffective means of inducing renters to become homeowners. Despite that tax treatment, the United States has about the same rate of home ownership as Canada, the United Kingdom, and Australia, which do not allow mortgage interest to be deducted. The deduction's effect on home buying may be small because lower-income households—which face greater barriers to home ownership—benefit less from it than higher-income households do. One reason is that the deduction has value only for owners whose total deductions exceed the standard deduction, so they have a reason to itemize. Lower-income homeowners are less likely to have deductions that large. Another reason is that the entire amount of the mortgage interest deduction can be used to reduce taxes only by people whose other deductions exceed the standard deduction. Lower-income people are less likely to have that many other deductions. Finally, for homeowners who itemize, the tax savings increase with their income tax rate and mortgage size. For example, an owner in the 15 percent tax bracket saves 15 cents per dollar of mortgage interest deducted, whereas an owner in the 35 percent bracket saves 35 cents. That larger saving per dollar deducted is magnified for higher-income households because they tend to buy larger homes with bigger mortgages.

The second approach in this option—replacing the mortgage interest deduction with a tax credit—would redirect the tax advantages of home ownership to lower-income taxpayers. Currently, many homeowners find themselves unable to take advantage of the deduction for mortgage interest. According to the President's Advisory Panel on Federal Tax Reform, only 54 percent of taxpayers who pay mortgage interest receive a tax benefit. Converting the mortgage interest deduction to a 15 percent credit would equalize the interest rate subsidy to borrowers regardless of their tax bracket and whether they itemized deductions.

The potential effectiveness of a 15 percent credit in getting more people to become homeowners is uncertain, however. That rate may be too low to encourage enough additional home ownership to improve neighborhoods and community participation. Alternatively, encouraging some people to own homes could reduce their flexibility with regard to job locations.

RELATED OPTION: Revenue Option 9

RELATED CBO PUBLICATION: *Taxing Capital Income: Effective Rates and Approaches to Reform,* October 2005

Option 8

Eliminate or Limit the Deduction of State and Local Taxes

(Billions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Revenues							
End the current deduction	+10.5	+42.1	+41.9	+53.3	+88.3	+236.1	+694.4
Cap the deduction at 2 percent of adjusted gross income	+6.7	+26.6	+26.3	+34.7	+62.2	+156.5	+471.5

Source: Joint Committee on Taxation.

In determining their taxable income, taxpayers may either claim a standard deduction or itemize certain expenses to deduct from their adjusted gross income (AGI). Such expenses have long included state and local taxes on income, real estate, and personal property. Under the American Jobs Creation Act of 2004, taxpayers who itemized deductions in 2004 and 2005 had the choice of deducting their state and local sales taxes, which previously had not been deductible, instead of their state and local income taxes. That provision was extended for 2006 and 2007 by the Tax Relief and Health Care Act of 2006.

This option would curtail the deductibility of state and local tax payments, either by eliminating the deduction or by allowing taxpayers to deduct such taxes only up to an amount equal to 2 percent of their AGI. Eliminating deductibility completely would increase federal revenues by a total of $236.1 billion between 2008 and 2012. Setting a ceiling for the deduction at 2 percent of AGI would raise revenues to a lesser degree: by $156.5 billion over that five-year period.

The federal income tax deduction for state and local taxes is effectively a federal subsidy to state and local governments. As such, it indirectly finances spending by those governments at the expense of other uses of federal revenues. Both variations of this option would substantially reduce the incentive that the current subsidy provides for state and local government spending. However, research indicates that total state and local spending is not very sensitive to that incentive.

Some proponents of curtailing the deduction argue that the federal government should not subsidize state and local governments in this manner; others argue that the deduction largely benefits wealthier localities, where many taxpayers itemize, are in the upper tax brackets, and enjoy more-abundant state and local government services. Because the value of an additional dollar of itemized deductions increases with the marginal tax rate (the rate on the last dollar of income), the deductions are worth more to taxpayers in higher income tax brackets than to those in lower brackets. Additionally, the deductibility of taxes may deter states and localities from financing services with nondeductible fees, which may be more efficient.

One argument against eliminating or restricting the current deduction involves the equity of the tax system. A person who must pay relatively high state and local taxes is less able to pay federal taxes than is someone with the same total income and a smaller state and local tax bill. The validity of that argument depends at least in part on whether people who pay higher state and local taxes also benefit from more publicly provided goods and services.

RELATED OPTION: Revenue Option 9

Option 9

Limit the Tax Benefit of Itemized Deductions to 15 Percent

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+26.6	+53.5	+54.7	+90.3	+127.2	+352.3	+1,040.6

Source: Joint Committee on Taxation.

Under current law, taxpayers may deduct various items from their taxable income, such as state and local income and property taxes, interest payments on home mortgages, contributions to charities, employee business expenses, moving costs, casualty and theft losses, and medical and dental expenses. A taxpayer benefits from itemizing those deductions if together they exceed the amount of the standard deduction. Some itemized deductions (such as the one for medical expenses) are limited to the amount in excess of a percentage of the taxpayer's adjusted gross income (AGI). For high-income people, the tax code lowers the value of itemized deductions by gradually reducing how much of those deductions taxpayers can subtract when their AGI rises above a certain level. (Under the Economic Growth and Tax Relief Reconciliation Act, or EGTRRA, that reduction is gradually being phased out, but it is scheduled to return in 2011 with EGTRRA's expiration.)

As with any deduction, the tax benefit of itemizing deductions rises with a taxpayer's marginal tax bracket (the bracket that applies to the last dollar of income). For example, $10,000 in itemized deductions reduces tax liability by $1,500 for someone in the 15 percent bracket but by $3,500 for someone in the 35 percent bracket.

This option would limit the tax benefit of itemizing deductions to 15 percent for people in marginal tax brackets above 15 percent, thus increasing revenues by $26.6 billion in 2008 and by $352.3 billion over five years. Of the roughly one-third of taxpayers who itemize deductions, about 40 percent are in tax brackets over 15 percent and therefore would receive smaller deductions under this option. (In 2007, those taxpayers would be single filers with taxable income of at least $31,850 and joint filers with income of at least $63,700.)

One rationale for curtailing the benefit from itemized deductions is economic efficiency. Limiting itemized deductions to 15 percent could have two efficiency-related benefits. First, to the extent that some current deductions provide larger subsidies for certain activities than is optimal for the most efficient allocation of society's resources, limiting the overall size of the tax benefit for itemized deductions might result in a more efficient allocation of those resources. Second, such a limit would weaken the link between a given deduction and a household's marginal tax bracket, thereby reducing the potentially inefficient variation that exists among households in the size of the deduction per dollar of activity. As a result, economic efficiency would improve in the case of deductions that are intended to subsidize socially beneficial activities (such as home ownership and charitable donations), though not in the case of deductions that are designed to measure income more accurately (such as the deduction for medical expenses)—but only if households in different marginal tax brackets do not differ systematically in the extent to which their decisionmaking is influenced by the subsidy that a given deduction provides. (In cases in which higher-income taxpayers are more sensitive to a subsidy than lower-income taxpayers are, eliminating the link between a deduction and a household's marginal tax bracket could worsen economic efficiency.)

Like other restrictions on itemized deductions, the one in this option could create incentives for taxpayers to avoid the constraint by converting itemized deductions into reductions in income. For example, taxpayers might liquidate some of their assets to repay mortgage loans, thus reducing both their income (from the assets) and their mortgage payments. Or they might donate time or services to charities rather than cash.

Another potential advantage or disadvantage of this option is that it would alter relative tax burdens. Reducing the benefit from itemized deductions would raise average tax rates disproportionately among upper-income taxpayers. It would also cause people who incurred high levels of deductible expenses to bear larger tax burdens relative to those of people who had fewer such expenses. That out-

come might be viewed as more problematic in the case of deductions that are intended to defray costs of an involuntary nature and to better measure underlying income, such as the deductions for casualty losses or business expenses.

RELATED OPTIONS: Revenue Options 7, 8, 10, and 11

Option 10

Limit Deductions for Charitable Giving to the Amount Exceeding 2 Percent of Adjusted Gross Income

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+7.8	+19.9	+21.4	+24.1	+25.6	+98.8	+249.8

Source: Joint Committee on Taxation.

Current law allows taxpayers who itemize deductions to deduct the value of their contributions to qualifying charitable organizations—up to a maximum of 50 percent of their adjusted gross income (AGI) in any year. By lowering the after-tax cost of donating to charities, the deduction provides an added incentive for such donations. In 2003 (the most recent year for which data are available), $145.7 billion in charitable contributions were claimed on 38.6 million tax returns.

This option would further limit the deduction for charitable donations—while preserving a tax incentive for donating—by allowing taxpayers to deduct only contributions that exceed 2 percent of their AGI. That change would extend the same tax treatment to charitable contributions that now applies to unreimbursed employee expenses, such as job travel costs and union dues. That approach would increase revenues by $7.8 billion in 2008 and by a total of $98.8 billion over the 2008–2012 period.

An argument for limiting the tax deductibility of charitable contributions is that a significant share of those donations would be made even without a deduction. In that case, allowing taxpayers to deduct contributions is economically inefficient because it results in a large subsidy (loss in federal revenue) for a very small increase in charitable giving. For taxpayers who contribute more than 2 percent of their AGI to charity, this option would maintain the current marginal incentive to donate but at much less cost to the federal government. People who make large donations are often more responsive to that tax incentive than are people who make small contributions. Moreover, smaller contributions are apt to be a source of abuse among taxpayers, some of whom overstate their charitable donations in the belief that the government is probably unwilling to incur the costs involved in determining the legitimacy of small contributions.

A potential disadvantage of this option is that total charitable giving would decline. People whose contributions do not exceed 2 percent of their AGI would no longer have a tax incentive to make donations; as a result, many of them would reduce their contributions. Although larger donors would still have an incentive to give, they would have slightly lower after-tax income because of the smaller deduction, which could lead them to reduce their contributions as well (though by a smaller percentage than among taxpayers whose donations do not exceed the 2 percent threshold). Another effect of creating a 2 percent floor for deducting charitable contributions is that it would encourage taxpayers who had planned to make gifts over several years to lump the donations together in one tax year to qualify for the deduction.

RELATED OPTION: Revenue Option 11

RELATED CBO PUBLICATIONS: *The Estate Tax and Charitable Giving,* July 2004; and *Effects of Allowing Nonitemizers to Deduct Charitable Contributions,* December 2002

Option 11

Create an Above-the-Line Deduction for Charitable Giving

(Billions of dollars)	2008	2009	2010	2011	2012	Total 2008-2012	Total 2008-2017
Change in Revenues							
Allow nonitemizers to deduct up to $100 of charitable donations ($200 for joint filers)	-0.2	-0.7	-0.7	-0.9	-0.9	-3.4	-7.9
Allow nonitemizers to deduct charitable giving of more than $250 ($500 for joint filers)	-0.7	-2.8	-2.9	-4.0	-4.3	-14.7	-38.7

Source: Joint Committee on Taxation.

Current tax law gives taxpayers an extra incentive to make donations to charitable organizations by allowing them to deduct the value of donations (up to a maximum of 50 percent of their adjusted gross income) if they itemize deductions. In 2003, 38.6 million tax returns claimed $145.7 billion in itemized charitable deductions. Taxpayers who do not itemize, however, are not permitted to deduct charitable contributions. In 2003, such taxpayers donated an estimated $30 billion to charities.

This option would expand the charitable deduction by letting people who chose not to itemize deductions take an "above-the-line" deduction from taxable income for some gifts to qualified charities. Nonitemizers could claim that deduction in addition to the standard deduction.

An above-the-line deduction for charitable contributions could take various forms. One alternative would allow nonitemizers to deduct up to $100 if filing singly or $200 if filing a joint return. That approach would decrease revenues by $0.2 billion in 2008 and by $3.4 billion over the 2008–2012 period. Another alternative would only allow nonitemizers to deduct total contributions in excess of $250 for single filers or $500 for joint filers. That change would have a larger effect, reducing revenues by $0.7 billion in 2008 and by $14.7 billion over five years.

Either approach would lower the after-tax cost of charitable giving for some nonitemizers, thus encouraging them to increase their donations. Under the first alternative, only taxpayers who would otherwise have given less than $100 to charity in a year would have an additional incentive to donate—and that incentive would only extend to contributions totaling $100 or less. Under the second approach, all taxpayers with taxable income of more than $250 and adjusted gross income of more than $500 would have an incentive to contribute at least $250 a year, and those who already donate that much would have a greater incentive to give more.

To the extent that charitable activities are currently provided at a less than socially optimal level, the main advantage of this option would be to increase contributions. The first approach would give more taxpayers a tax reduction to offset the cost of their donations. The second alternative might be more effective at boosting charitable donations, however, because it would lower the after-tax cost of additional giving for the many nonitemizing taxpayers who already contribute more than $250 to charity. In general, proponents argue that either approach would be a step toward equalizing the tax treatment of itemizers and nonitemizers.

Creating an above-the-line charitable deduction would have at least three drawbacks, however. First, it would be a costly way—in terms of forgone revenue—to expand charitable contributions. Many nonitemizers who already make such contributions would receive a tax benefit even if they did not increase their donations. Overall, any rise in donations would most likely be small relative to the cost in lost tax revenue, since the after-tax cost of giving probably has a bigger effect on decisionmaking among itemizers than among nonitemizers. Moreover, especially under the first alternative, the after-tax cost of giving an additional dollar to charity would not change for the many taxpayers who currently donate more than $100 a year.

Second, to the extent that the standard deduction incorporates an implicit allowance for charitable contributions, nonitemizers are already effectively deducting their donations. Because nonitemizers have the option of itemizing deductions, their decision not to do so suggests that they are better off claiming the standard deduction. This option would thus allow nonitemizers to explicitly deduct some of their contributions in addition to benefiting from the implicit allowance incorporated in the standard deduction.

Third, by substantially increasing the number of tax returns that claim a deduction for charitable contributions, this option would significantly raise either the costs of tax enforcement or abuse by taxpayers who overstate their charitable donations.

RELATED OPTION: Revenue Option 10

RELATED CBO PUBLICATIONS: *The Estate Tax and Charitable Giving,* July 2004; and *Effects of Allowing Nonitemizers to Deduct Charitable Contributions,* December 2002

Option 12

Eliminate Tax Subsidies for Child and Dependent Care

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.7	+2.8	+2.7	+2.6	+2.5	+11.3	+22.6

Source: Joint Committee on Taxation.

The tax system provides two types of assistance for employed taxpayers who incur expenses to care for children under age 13 or disabled dependents. The first type is a tax exclusion, in which the amount of such expenses provided by an employer is excluded from an employee's taxable income. The second type of subsidy is a tax credit, which is equal to a percentage of a taxpayer's expenses for child or dependent care. The credit is available only to people who do not use the employment-based exclusion.

This option would eliminate both types of subsidy beginning in 2008. That change would add $0.7 billion to federal revenues in 2008 and a total of $11.3 billion through 2012. (In the case of the tax exclusion, including employers' contributions for child or dependent care in taxable income—and thus in the wage base from which Social Security benefits are calculated—would also increase federal spending for Social Security over the long run.)

Taxpayers are eligible for the exclusion if their employer either provides child or dependent care directly or offers a qualified plan that provides it. As much as $5,000 in child and dependent care expenses may be excluded from the taxable wages of employees. However, the amount excluded may not exceed the employee's earnings or, in the case of married taxpayers, the wages of the lower-earning spouse.

Taxpayers who do not receive the employment-based subsidy can claim a nonrefundable credit against their income tax for child or dependent care costs. The credit is limited to expenses of $3,000 for one dependent or $6,000 for two or more dependents. (As with the exclusion, the total amount of qualifying expenses may not exceed the earnings of the taxpayer or, in the case of a couple, those of the lower-earning spouse.) For taxpayers with adjusted gross income (AGI) of $15,000 or less, the credit equals 35 percent of qualifying expenses; that rate phases down to 20 percent for taxpayers whose AGI is at least $43,000. The 20 percent rate is the one that applies to most taxpayers. It results in a maximum credit of $600 for one dependent or $1,200 for two or more dependents. (The current parameters of the child and dependent care credit were established in the Economic Growth and Tax Relief Reconciliation Act of 2001. If that law expires as scheduled in 2011, both the amount of allowable expenses and the rate structure of the credit will revert to their previous, lower levels.)

Although the credit and the exclusion subsidize the same activities, they provide significantly different benefits. For example, a high-income taxpayer with one child could see his or her income taxes reduced by as much as $1,750 under the employment-based exclusion but by only $600 under the credit. In addition, by lowering taxable income, the exclusion reduces an employee's payroll taxes, whereas the credit does not.

One rationale for eliminating both the exclusion and the credit is to make the tax system less complex by simplifying how people calculate their income taxes. Moreover, several other provisions of the tax system—such as personal exemptions, the child credit, and the earned income credit—reduce taxes for families with children. Another argument for removing subsidies for child and dependent care would be fairness: Taxpayers who are alike in other respects face unequal tax burdens depending on whether they opt to pay for child care rather than choosing parental or informal care.

A rationale against eliminating the exclusion is that employer-provided dependent care could be considered part of the cost of employment. The tax code permits some other employment-related expenses (such as the cost of moving to a new job or purchases of supplies and equipment in excess of 2 percent of income) to be deducted from employees' taxable income. In addition, research has shown that among couples, the extent to which the lower-earning spouse works is particularly sensitive to tax rates. Both the exclusion and the credit lower

the cost of working for taxpayers with dependents. In the absence of those tax subsidies, a lower-earning spouse could decide to stop working and care for dependents rather than pay someone else to do it. Consequently, eliminating the subsidies might lessen the labor force participation of those spouses.

RELATED OPTIONS: Revenue Options 13, 14, 15, and 23

Option 13

Include Employer-Paid Premiums for Income-Replacement Insurance in Employees' Taxable Income

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+8.1	+19.0	+19.8	+20.5	+21.8	+89.2	+209.3

Source: Joint Committee on Taxation.

Current tax law treats benefits that replace income for unemployed, injured, or disabled people in different ways. Unemployment benefits are fully taxable, whereas benefits paid under workers' compensation programs (for work-related injuries or illnesses) are exempt from taxation. Disability benefits (for non-work-related injuries) may be taxable or not depending on who paid the premiums for the disability insurance. If those premiums were paid by an employer, the benefits are taxable (although the recipient's tax liability may be partly offset by the special income tax credit given to elderly or disabled people). If the employee paid the premiums for disability insurance out of after-tax income, the benefits are not taxed.

This option would eliminate existing taxes on income-replacement benefits. However, it would include in employees' taxable income several taxes, premiums, and contributions that employers pay. Specifically, taxes paid under the Federal Unemployment Tax Act and the various state unemployment programs, 60 percent of premiums for workers' compensation (that is, excluding the part that covers medical expenses), and the portion of insurance premiums or contributions to pension plans that funds disability benefits would all become taxable under the individual income tax. Together, those changes would increase revenues by $8.1 billion in 2008 and by $89.2 billion through 2012. Over the long term, the revenue gain would result almost entirely from adding workers' compensation premiums to taxable income. (Including those various items in employees' taxable income, and thus in the wage base from which Social Security benefits are calculated, would also increase federal spending for Social Security over the long run.)

Treating different kinds of income-replacement insurance similarly would eliminate the current, somewhat arbitrary discrepancies that exist in the taxation of various income-replacement benefits. For example, people who were unable to work because of injury would not be taxed differently depending on whether the injury was related to their previous job. Furthermore, this option would spread the tax burden among all workers covered by such insurance rather than place the burden on people unfortunate enough to need benefits, as is currently the case with unemployment insurance and employer-paid disability insurance.

This option would not eliminate all of the disparities in the treatment of income-replacement benefits, however. For example, the income-replacement portion of adjudicated awards and out-of-court settlements for injuries that were not related to work and not covered by insurance would remain entirely exempt from taxation. Also, recipients of the supplemental unemployment benefits that lawmakers occasionally appropriate during economic downturns would receive those benefits tax-free, even though no employer-paid taxes had been included in their taxable income. Another disadvantage of this option is that exempting unemployment benefits from taxation would reduce the incentive for unemployed people to accept available work.

RELATED OPTIONS: Revenue Options 12, 14, and 15

Option 14

Eliminate the Tax Exclusion for Employer-Paid Life Insurance

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.4	+2.1	+2.2	+2.3	+2.4	+10.4	+23.6

Source: Joint Committee on Taxation.

Many workers receive part of their compensation in the form of noncash employer-paid benefits that are not subject to income or payroll taxes. For example, current law excludes the premiums that employers pay for employees' group term life insurance from the employees' taxable income. The amount that can be excluded is limited to the cost of premiums for the first $50,000 of insurance. Employer-paid life insurance is the third largest tax-exempt fringe benefit (after health insurance and pensions) as measured by lost federal revenues.

This option would eliminate that exclusion by counting all premiums for employer-paid life insurance in employees' taxable income. That change would increase federal revenues by a total of $10.4 billion over the 2008–2012 period—$6.2 billion in individual income tax revenues and $4.2 billion in payroll tax revenues. (However, including employers' contributions for life insurance in taxable income, and thus in the wage base from which Social Security benefits are calculated, would also increase federal spending for Social Security over the long run.)

The main rationales for not excluding life insurance premiums from taxation would be to enhance the efficiency and equity of the tax system. Like the tax exclusions for other employment-based fringe benefits (such as child care), the exclusion for life insurance premiums creates an incentive for employees to buy more life insurance than they would if they had to pay the full cost themselves. That subsidy results in employees' receiving more compensation in the form of life insurance and less cash compensation, which is fully taxed. In terms of fairness, excluding premiums from taxation allows workers whose employers purchase life insurance for them to pay less tax than workers who have the same total compensation but must buy their own insurance. Moreover, self-employed people cannot exclude their life insurance premiums from taxable income. Finally, the exclusion links the size of the tax incentive to a household's marginal tax rate (the rate on the last dollar of income), which generally results in larger subsidies for taxpayers with higher income.

Another argument for this option is the relative ease with which it could be implemented. Unlike the value of some other noncash benefits, the value of employer-paid life insurance can be accurately measured. As a result, employers could report the insurance premiums they paid for each employee on the employee's W-2 form and compute withholding using the same method that they use for wages. Indeed, employers already withhold taxes on the premiums they pay for life insurance over the $50,000 limit.

Some opponents of eliminating the tax exclusion argue that people systematically underestimate the financial hardship that their death might bring to their family and thus purchase too little life insurance. If that view is correct, the incentive offered by the exclusion has benefits for society because people who bore the full cost of life insurance would purchase too little of it. (In that case, a more efficient method for encouraging people to buy life insurance would be to extend favorable tax treatment to all purchasers instead of only to workers whose insurance is provided by their employers.)

RELATED OPTIONS: Revenue Options 12, 13, 15, and 16

Option 15

Reduce the Tax Exclusion for Employer-Paid Health Insurance

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+26.5	+45.5	+58.1	+72.5	+87.5	+290.1	+999.2

Source: Joint Committee on Taxation.

Although they are part of many employees' total compensation, employer-paid premiums for health insurance are exempt from individual income taxes and payroll taxes. Besides that exclusion, current law offers employees another tax advantage for health-related expenditures: Spending from employer-sponsored flexible spending accounts (FSAs) and health savings accounts (HSAs) is also tax-exempt.

This option would limit the extent to which employer-paid health insurance premiums and health spending from FSAs and HSAs were excluded from taxation. Specifically, it would include in employees' taxable income any contributions that employers or employees made for health insurance and for health care costs (through accounts such as FSAs) that together exceeded $910 a month for family coverage or $340 a month for individual coverage. Those limits—which are based on the average health insurance premiums paid by or through employers in 2005—would not be indexed for inflation.

Such a restriction would increase revenues from income and payroll taxes by a total of $290.1 billion over the 2008–2012 period and by nearly 2.5 times that amount over the following five years. (However, including employers' contributions for health care coverage in taxable income—and thus in the wage base from which Social Security benefits are calculated—would also increase federal spending for Social Security over the long run.)

Many analysts believe that the tax preference for employer-provided health insurance distorts the markets for health insurance and health care. Those two markets are closely linked. Current tax law provides incentives for health insurance plans to cover routine expenses as well as large, unexpected costs because routine charges are subsidized only if they are paid through an insurance plan. That factor can drive up overall health care costs. Under this option, employees and their employers would have an incentive to economize, which could reduce upward pressure on health care prices and encourage the use of more-cost-effective types of care.

Limiting the tax exclusion for employer-paid health insurance premiums could have other benefits as well. It would reduce the incentive that companies have to offer special health care packages to top executives. In addition, it would create a more level playing field between employer-provided and other forms of health insurance.

One argument against this option is that setting fixed dollar limits on excluded health care spending would have different effects in different locations. For example, the additional costs subject to taxation would be greatest for workers who lived in areas where health care was more expensive and whose firms offered generous health benefits. Limiting the subsidy for employer-paid insurance premiums would probably result in employees' paying a larger share of their premiums directly, which might induce some workers to forgo health insurance. Finally, this option might lead some firms to stop offering health insurance coverage. A key factor in evaluating the effects of less employment-based coverage is whether alternative insurance pools would develop outside the context of employment.

RELATED OPTIONS: 550-11 and Revenue Options 12, 13, and 14

RELATED CBO PUBLICATIONS: *Consumer-Directed Health Plans: Potential Effects on Health Care Spending and Outcomes,* December 2006; *The Price Sensitivity of Demand for Nongroup Health Insurance,* August 2005; *How Many People Lack Health Insurance and for How Long?* May 12, 2003; and *Testimony on the Tax Treatment of Employment-Based Health Insurance,* April 26, 1994

Option 16

Include Investment Income from Life Insurance and Annuities in Taxable Income

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+11.4	+23.1	+23.7	+25.6	+27.6	+111.4	+260.5

Source: Joint Committee on Taxation.

Life insurance policies and annuities often combine features of both insurance and tax-favored savings accounts. (An annuity is a contract with an insurance company under which, in exchange for premiums, the company agrees to make a series of fixed or variable payments to a person at a future time, usually during retirement.) The investment income from the money paid into life insurance policies and annuities—sometimes called inside buildup—is not included in taxable income until it is paid out to the policyholder. If that accumulated income is left to the policyholder's estate or used to finance life insurance (such as in the case of whole-life policies), it can escape inclusion and taxation entirely. The tax treatment of inside buildup is similar to the treatment of another type of investment income, capital gains.

Under this option, life insurance companies would inform policyholders annually of the investment income that had been realized on their account—just as mutual funds do now—and policyholders would include those amounts in their taxable income for that year. In turn, disbursements from life insurance policies and benefits from annuities would no longer be taxable when they were paid. That approach would make the tax treatment of investment income from life insurance and annuities match the treatment of income from bank accounts, taxable bonds, or mutual funds. (Investment income from annuities purchased as part of a qualified pension plan or qualified individual retirement account would still be tax-deferred until benefits were paid.) Those changes in tax treatment would increase revenues by $11.4 billion in 2008 and by a total of $111.4 billion over the 2008–2012 period.

By taxing the investment income from life insurance and annuities as it was realized, this option would eliminate a tax incentive to purchase such insurance. Whether that outcome would be a benefit or a drawback depends on whether the current incentive is considered beneficial. Encouraging the purchase of life insurance is useful if people systematically underestimate the financial hardship that their death will impose on their family and thus buy too little life insurance. Encouraging the purchase of annuities is helpful if people tend to underestimate their retirement spending or life span and thus buy too little annuity insurance to protect themselves from outliving their assets. However, little evidence exists about how successful the current tax treatment is in reducing underinsurance.

A disadvantage of the present treatment is that it provides no tax incentive to buy term life insurance, because such insurance has no savings component on which to defer taxation. (Term life insurance provides coverage for a specified period of time and pays benefits only if the policyholder dies during that period. Otherwise, the policy expires without value.) Term insurance accounts for a major share of all life insurance policies.

If some incentive to purchase life insurance is indeed considered a useful part of the tax system, an alternative approach may be to encourage such purchases directly by giving people a tax credit for their life insurance premiums or by allowing them to deduct part of those premiums from their taxable income. (Annuities already receive favorable tax treatment through special provisions for pensions and retirement savings.)

RELATED OPTION: Revenue Option 14

Option 17

Include All Income Earned Abroad by U.S. Citizens in Taxable Income

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.0	+5.1	+5.3	+5.6	+5.9	+22.9	+57.0

Source: Joint Committee on Taxation.

U.S. citizens who live in other countries must file a tax return each year but may exclude from taxation some of the income they earn abroad: up to $82,400 for single filers and $164,800 for joint filers in calendar year 2006. (Those amounts are indexed for inflation.) The tax exclusion for overseas income—along with one for foreign housing and the usual personal exemptions and deductions—means that U.S. citizens who reside abroad and earn close to $100,000 may not incur any U.S. tax liability, even if they pay no taxes to the country in which they live. Moreover, U.S. citizens with foreign-earned income above the exclusion amount receive a credit for taxes they pay to foreign governments, which may also eliminate their U.S. tax liability on that income. (The Tax Increase Prevention and Reconciliation Act of 2005 included several technical changes that made the tax exemption less generous overall.)

This option would retain the credit for taxes paid to foreign governments but would require U.S. citizens living overseas to include all of the income they earned abroad in their adjusted gross income. As a result, U.S. citizens residing in foreign countries with higher tax rates than those in the United States would generally not owe U.S. taxes on their earned income, whereas those living in lower-tax countries could have some U.S. tax liability. That change would increase revenues by $22.9 billion over the 2008–2012 period.

One rationale for eliminating the partial exclusion for foreign earnings is that U.S. citizens with similar income should incur similar tax liabilities, regardless of where they live or what level of services they receive. That principle is violated if people can move to low-tax foreign countries and escape U.S. taxation while retaining their U.S. citizenship. In addition, the existing exclusion represents an implicit subsidy to corporations that employ U.S. citizens abroad, because those companies can pay their employees less than they would if the income were fully subject to U.S. taxes. Moreover, ending the exclusion for foreign-earned income would lessen some of the complexity of the tax code.

Opponents of this option argue that U.S. citizens who live in other countries should not face the same tax treatment as U.S. residents because they do not receive the same services from the U.S. government. Opponents also maintain that excluding foreign-earned income promotes exports by U.S. multinational firms by making it cheaper for those companies to hire U.S. employees to live and work abroad.

Option 18

Tax Social Security and Railroad Retirement Benefits Like Defined-Benefit Pensions

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+12.5	+25.5	+26.6	+31.6	+36.6	+132.8	+343.9

Source: Joint Committee on Taxation.

Under current law, roughly three-quarters of the total benefits paid by the Social Security and Railroad Retirement programs are not subject to income taxation. Recipients pay tax only if the sum of their adjusted gross income, their nontaxable interest income, and one-half of their Social Security and Tier I Railroad Retirement benefits exceeds a fixed threshold. If that total is more than $25,000 for a single taxpayer or $32,000 for a couple filing jointly, up to 50 percent of the benefits are taxed. Above a second set of thresholds—$34,000 for single filers and $44,000 for joint filers—as much as 85 percent of the benefits are taxed. Together, those levels constitute a three-tiered structure for taxing Social Security and Railroad Retirement benefits. However, most recipients fall in the first tier, so their benefits are not taxed.

Distributions from defined-benefit pension plans, by contrast, are taxable unless those payments represent the recovery of an employee's "basis," or after-tax contributions to the plan. Each year, a certain percentage of a recipient's distribution is deemed to be nontaxable basis recovery. That percentage (which is determined in the year that distributions begin) is based on the recipient's life expectancy and cumulative amount of after-tax contributions. Once the recipient has recovered his or her entire basis tax-free, all subsequent pension distributions are fully taxed. Until recently, distributions from defined-contribution plans and individual retirement accounts (IRAs) were taxed similarly to those from defined-benefit plans. Now, however, all workers have the opportunity to make after-tax contributions to so-called Roth plans; distributions from those plans are entirely tax-exempt—a more favorable treatment than the tax-free recovery of basis only.

This option would define a basis in Social Security and Railroad Retirement benefits and would tax only benefits in excess of that basis, in the same manner as with defined-benefit pensions. The basis would be the payroll taxes that employees pay out of their after-tax income to support those programs (as opposed to the equal amount that employers pay on their workers' behalf). For self-employed people, the basis would be determined using 100 percent of payroll taxes minus the half they can deduct on their income tax returns. Under such an approach, the percentage of benefits subject to income taxation would exceed 85 percent for the overwhelming majority of recipients. As a result, revenues would increase by $12.5 billion in 2008 and by $132.8 billion over the 2008–2012 period.

Taxing Social Security and Railroad Retirement benefits like defined-benefit pensions would make the tax system more equitable in at least two ways. First, it would eliminate the preferential treatment that the tax code now accords to Social Security benefits but not to pension benefits, which is slight in the case of higher-income taxpayers but much larger in the case of low- and middle-income taxpayers. Second, it would treat elderly taxpayers in the same way as nonelderly taxpayers with comparable income. In addition, the option would make preparing tax returns for elderly people much simpler.

At the same time, however, taxing Social Security and Railroad Retirement benefits like defined-benefit pensions would have several drawbacks. One is that more elderly people would have to file tax returns than is the case now. In addition, retirees might feel that raising taxes on Social Security and Railroad Retirement benefits would violate the implicit promises of those programs. Furthermore, calculating the percentage of each recipient's benefits that would be excluded from taxation would impose an additional burden on the Social Security Administration. Finally, this option would not provide the same tax benefits enjoyed by the increasingly popular defined-contribution plans and IRAs.

RELATED CBO PUBLICATION: *Social Security: A Primer,* September 2001

Option 19

End the Preferential Treatment of Dividends Paid on Stock Held in Employee Stock Ownership Plans

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.4	+0.8	+0.8	+0.9	+1.0	+3.9	+9.9

Source: Joint Committee on Taxation.

Employee stock ownership plans (ESOPs) are a type of retirement plan designed to encourage a company and its shareholders to contribute or sell stock to the company's employees. ESOPs provide more tax advantages than other qualified retirement plans do. Corporations that sponsor ESOPs typically contribute their own stock rather than cash to the plan on their workers' behalf. Those contributions, like employers' contributions to other qualified retirement plans, can be deducted from the company's taxable income. But employers with ESOPs have an additional tax advantage: they can deduct the dividends paid on stock held in an ESOP, provided those dividends are paid directly to the plan's participants or are paid to the plan and either reinvested in additional company stock, used to repay loans with which the stock was originally purchased, or distributed to participants within 90 days of the end of the plan year.

Another advantage associated with ESOPs is that when shareholders sell the sponsoring company's stock to such a plan, they can defer paying taxes on capital gains from the sale, under certain circumstances. (Those conditions include that the company is a C corporation and thus subject to the corporate income tax, that the stock is not traded publicly, and that the proceeds of the sale are invested in the stock of another U.S. company.)

This option would eliminate the tax advantages that are now accorded to ESOPs, effectively rendering them indistinguishable from other qualified retirement plans. That change would increase revenues by $0.4 billion next year and by $3.9 billion over the next five years.

Several arguments can be made for not giving preferential tax treatment to ESOPs. First, the current treatment causes similar dividend payments to have different tax consequences for different companies. Second, it hinders the diversification of employees' retirement portfolios, because the assets of an ESOP, by design, consist primarily of shares of the employer's stock. If the price of that stock drops, employees may have much less wealth in retirement than they would have had if they had been allowed to diversify their investments, as participants in a typical 401(k) plan can. A third argument for eliminating ESOPs' preferential tax treatment is that the plans have occasionally been used for purposes for which they were not intended, such as to ward off hostile takeovers by placing large numbers of shares in friendly hands.

The main rationale for retaining the tax advantages of ESOPs is that having employees own stock directly links their financial interests to their productivity. That is, greater productivity translates into higher profits for the company and thereby increases the value of the employees' stock. To the extent that the incentive of stock ownership works as intended, ESOPs help promote increased productivity among workers. However, the efficacy of that incentive has not been clearly established.

Option 20

Include Social Security Benefits in Calculating the Phaseout of the Earned Income Tax Credit

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues[a]	*	+0.7	+0.7	+0.8	+0.7	+3.0	+7.0

Source: Joint Committee on Taxation.

Note: * = between zero and $50 million.

a. These estimates represent the change in the overall budget balance resulting from the sum of changes to both revenues and outlays.

The earned income tax credit (EITC)—a refundable credit designed to help low-income workers and their families—phases out as a taxpayer's earned income or adjusted gross income (AGI), whichever is larger, exceeds a certain threshold. Under the tax code, AGI does not include some income from government transfer programs, such as Social Security. Consequently, low-income families who receive sizable transfer payments may qualify for a larger EITC than otherwise comparable families with the same total income whose income stems entirely from sources included in AGI.

In the case of Social Security, the tax code requires single filers with income above $25,000 and joint filers with income above $32,000 to count up to 85 percent of their Social Security benefits in AGI. This option would extend that requirement by mandating that taxpayers who might be eligible for the EITC include all of their Social Security benefits in a modified AGI that would be used for phasing out the earned income tax credit. That change would increase federal revenues and decrease outlays for the EITC by a total of $3.0 billion over the 2008–2012 period.

The main rationale for counting all Social Security benefits when calculating the phaseout of the EITC would be to make the credit fairer with a minimum of administrative difficulty. Low-income taxpayers who receive Social Security benefits and those whose income is derived entirely from sources that are fully included in AGI would be treated the same way. Moreover, because the Internal Revenue Service already receives information about taxpayers' Social Security benefits, the option could be implemented with only minor procedural changes. (By comparison, a broader option that included income from other transfer programs in the modified AGI would be difficult to administer because not all of the necessary information is currently collected. Moreover, if all transfer payments were counted for phasing out the EITC, lawmakers would have to adjust other parameters of the credit if they wished to maintain the same level of subsidy for low-income workers.)

A drawback of this option is that counting Social Security benefits in phasing out the EITC would make claiming the credit more complex. Potential EITC claimants with Social Security income would have to compute a modified AGI in addition to their regular AGI, which would further complicate the already complex form that such taxpayers must fill out. That result would run counter to recent efforts to simplify the procedures for claiming the earned income tax credit.

Option 21

Replace the Tax Exclusion for Interest Income on State and Local Bonds with a Tax Credit

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.3	+0.6	+1.0	+1.3	+1.7	+4.9	+19.1

Source: Joint Committee on Taxation.

The tax code allows owners of state and local bonds to exclude the interest they earn on those bonds from their adjusted gross income (AGI) and thus from income taxation. As a result, state and local governments can pay lower rates of interest on such debt than would be paid on bonds of comparable risk whose interest was taxable. The revenue that the federal government forgoes because of that exclusion—more than $32 billion per year—effectively pays part of the costs that state and local governments incur when they borrow.

This option would replace the current exclusion for such interest income with a tax credit that—unlike most credits—would be included in taxpayers' AGI. Under the option, a bondholder would receive a taxable interest payment from the state or local government that issued the bond as well as a federal tax credit that would give the bondholder an after-tax return comparable to the return on a tax-exempt bond. That change would increase federal revenues by $0.3 billion next year and by $4.9 billion over the next five years. (The option would retain restrictions, such as those on arbitrage earnings, that now apply to the issuance of tax-exempt bonds by state and local governments.)

Creating a tax credit for the interest paid on state and local debt could have several advantages. First, it could lower states' and localities' borrowing costs to a similar extent as the current tax exclusion but with a smaller reduction in federal revenues. The drop in revenues would be smaller because switching to the credit in this option would prevent bondholders in higher tax brackets from receiving gains that exceeded the investment return necessary to induce them to buy the bonds. Second, the size of the tax credit could be varied to allow lawmakers to adjust the extent of the federal subsidy—on the basis of its perceived benefit to the public—for different categories of state and local government borrowing. (Even with a tax credit, however, the federal subsidy would remain akin to an entitlement; that is, it would not automatically be subject to annual Congressional scrutiny.)

Opponents of switching to a tax credit argue that it could raise the interest rate that state and local governments pay to borrow funds. For example, the credit would reduce the after-tax returns on state and local bonds for people who are subject to high marginal tax rates (the rate on the last dollar of income) and thus could lead them to buy fewer of those bonds. If the drop in demand from those taxpayers was not offset by increased demand from other investors, state and local governments' borrowing costs would be reduced by a smaller percentage than they are now, and interest rates on state and local debt would rise. Paying higher rates for borrowing could in turn cause states and localities to reduce their spending on schools, roads, and other capital facilities that are frequently financed by issuing bonds.

RELATED CBO PUBLICATIONS: *Testimony on Economic Issues in the Use of Tax-Preferred Bond Financing,* March 16, 2006; and *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures,* July 2004

Option 22

Consolidate Tax Credits and Deductions for Education Expenses

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.6	+2.3	+2.3	+2.3	+2.1	+9.6	+19.8

Source: Joint Committee on Taxation.

In recent years, the ways in which the federal government supports postsecondary education through the tax system have grown more numerous and complex. In addition to the myriad tax-preferred savings vehicles, taxpayers currently benefit from several education-related credits and deductions:

- The nonrefundable Hope credit, which allows people to subtract up to $1,650 for qualifying tuition and fees from the amount of income tax they owe. (Technically, the credit subsidizes 100 percent of the first $1,100 of those expenses and 50 percent of the next $1,100. Those amounts are indexed for inflation.) A Hope credit can be claimed for each student in a household, provided that the student is the taxpayer or the taxpayer's spouse or dependent, the expenses claimed under the credit apply to the first two years of a postsecondary degree or certificate program, and the student is enrolled at least half-time.

- The nonrefundable Lifetime Learning credit, which allows people to subtract up to $2,000 for qualifying tuition and fees from the amount of income tax they owe. (The credit subsidizes 20 percent of each dollar of qualifying expenses up to a maximum of $10,000.) Only one Lifetime Learning credit may be claimed per tax return per year, but the credit may cover expenses for more than one family member. Like the Hope credit, the Lifetime Learning credit applies to taxpayers and their spouses and dependents. But unlike the Hope credit, it can be used for expenses beyond the first two years of postsecondary education and for students who attend school less than half-time. However, a taxpayer may not claim both credits for the same student in the same year.

- A maximum deduction of $2,500 for interest paid on student loans.

To qualify for those credits and deductions, taxpayers and students must meet various conditions (in addition to those noted above). Moreover, each of the benefits phases out for taxpayers with income above a certain point.

This option would combine the benefits provided by the Hope and Lifetime Learning credits and the student loan interest deduction into a single tax credit for higher education. For students in their first two years of postsecondary school, the first $10,000 of tuition and fees would qualify for a 20 percent nonrefundable subsidy. For students more than two years into their postsecondary education or for those attending school less than half-time, the credit would have a 15 percent subsidy rate. Although the current deduction for interest on student loans would be eliminated, the first $2,500 of such interest would count as a qualifying tuition expense under the new credit. The credit could be claimed for each student in a household.

Under this option, the starting point of the phaseout range for the tax credit would rise slightly, to $50,000 for single filers and $100,000 for joint filers (amounts that would be indexed for inflation). Beyond that point, each additional dollar of modified adjusted gross income (AGI) would reduce the credit by 5 cents until the credit was completely phased out.[1] Thus, a single filer who qualified for a $2,000 credit would see the credit fully phase out at an AGI of $90,000. With that structure, the new credit would raise revenues by $9.6 billion over the 2008–2012 period.

Creating a unified education credit would have two main advantages: It would simplify the tax code's preferences for higher education, and it would most likely provide higher average benefits to households with students than current law does.

1. For most taxpayers, modified AGI is the same as regular AGI. Modified AGI begins with AGI as the base and then applies certain tax exclusions and deductions.

Some taxpayers, however, would benefit less from the new credit than they do from the present system of education-related credits and deductions. Like the Lifetime Learning credit, the new credit would subsidize 20 percent of qualifying education expenses. But for a taxpayer whose marginal tax rate (the rate on the last dollar of income) was more than 20 percent, substituting the new credit for the deduction of interest on student loans could result in lower benefits. For example, someone with a marginal tax rate of 25 percent who paid $1,000 in student loan interest would receive a benefit of $150 under this option, compared with $250 under current law.

RELATED CBO PUBLICATION: *Private and Public Contributions to Financing College Education,* January 2004

Option 23

Eliminate or Limit Eligibility for the Child Tax Credit

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues							
Eliminate the child tax credit	+9.2	+46.1	+46.0	+39.8	+14.9	+156.0	+223.3
Reduce the eligibility age to 13	+2.1	+10.6	+10.3	+8.8	+3.3	+35.1	+49.6

Source: Joint Committee on Taxation.

The child tax credit, enacted in the Taxpayer Relief Act of 1997, allows taxpayers to claim a partially refundable credit against their federal income tax liability for each eligible child. To qualify, a child must be 17 or younger at the close of the year and be able to be claimed as a dependent by the taxpayer. Since 2001, the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) and other laws have expanded the credit, raising it from $500 to $1,000 per child and making it refundable for taxpayers with one or two children. Just under 26 million taxpayers claimed the expanded credit in 2004 (the most recent year for which data are available). In 2011, the credit is scheduled to revert to its pre-EGTRRA form, with a credit amount of $500 that is refundable only to families with three or more children.

Under current law, the maximum child credit that taxpayers can receive as a refund is an amount equal to 15 percent of their earned income over an inflation-indexed threshold that depends on family size. The credit phases out for single filers with adjusted gross income of more than $75,000 or joint filers with income above $110,000 (thresholds that are not indexed for inflation).

This option would either eliminate the child tax credit or lower the age limit for eligible children from 17 to 13. The first approach would increase income tax revenues by a total of $156.0 billion from 2008 through 2012; the second would raise revenues by $35.1 billion over that five-year period.

Supporters of eliminating or curtailing the child tax credit argue that other features of the individual income tax—such as the standard deduction, personal exemptions, dependent care tax credit, and earned income tax credit—already provide significant tax preferences to families with children, particularly those whose income is near the poverty line. Moreover, the credit does not benefit many of the poorest families because they have no income tax liability, whereas households must have income of at least $11,300 to receive the refundable portion of the credit. Another argument for reducing the credit is that the choice to have children represents a family's decision about how to spend its income—a choice that could be considered analogous to other spending decisions.

Opponents of cutting the child tax credit argue that the other preferences in the tax code do not fully account for the costs of raising children. In that view, because those costs can be considered an investment in the future, people should receive an income tax credit for them.

RELATED OPTION: Revenue Option 12

Option 24

Set the Corporate Tax Rate at 35 Percent for All Corporations

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.5	+3.0	+2.9	+2.9	+2.9	+13.2	+27.6

Source: Joint Committee on Taxation.

Under current law, C corporations (those subject to the corporate income tax) pay taxes according to a progressive schedule of four statutory rates. The first $50,000 of corporate taxable income is taxed at a rate of 15 percent; income from $50,000 to $75,000 is taxed at 25 percent; income from $75,000 to $10 million is taxed at 34 percent; and income over $10 million is subject to the top corporate tax rate, 35 percent.

This option would replace those multiple rates with a single statutory rate of 35 percent on all corporate taxable income. If that change took effect in 2008, it would raise revenues by $1.5 billion in that year and by a total of $13.2 billion over the first five years.

In addition to the statutory rates listed above, some amounts of corporate taxable income face other rates. Income between $100,000 and $335,000 is subject to a further tax of 5 percent, and an additional 3 percent tax is levied on income between $15 million and $18.3 million. Those additional taxes effectively phase out the benefit of the 15 percent, 25 percent, and 34 percent tax rates for corporations with income above certain amounts. For example, a firm with taxable income of at least $18.3 million pays an average tax rate of 35 percent, despite paying the lower rates on the first $10 million. This option would not alter the taxes that those firms pay. Nor would it affect firms that operate as S corporations or as limited liability companies. (Owners of such enterprises pay taxes on their total business income but at the rates of the individual income tax.)

The progressive rate schedule for the corporate income tax was designed in part to lessen the effect of "double taxation," in which the government taxes the earnings of C corporations once at the corporate level and again at the individual level if those earnings are distributed to shareholders. The current rate structure is intended to encourage entrepreneurship and provide some tax relief to businesses with small and moderate levels of profit. Of the roughly 1 million corporations that typically owe corporate income taxes each year, all but a few thousand benefit from the schedule's reduced rates. (Because the firms that benefit earn only about 10 percent to 15 percent of all corporate taxable income, however, the reduced rates have a limited effect on tax revenues.)

One argument for creating a flat corporate income tax is that many of the companies that benefit from the current rate structure are not small or medium-sized firms, which goes against the original rationale for the rates' progressivity. For example, under current law, large corporations can reduce their taxable income for certain years by sheltering some of it or by controlling when they earn income and incur expenses. The current system also allows individuals in a small corporation to shelter income by retaining earnings rather than paying them out as dividends. (That benefit does not apply to owners of personal-services corporations—such as physicians, attorneys, and consultants—whose firms are already taxed at a flat rate of 35 percent.) Finally, the lower tax rates on dividends and capital gains that were enacted in 2003 undercut part of the rationale for the existing corporate tax rate structure by alleviating much of the "double taxation" of C corporations' profits.

A disadvantage of this option is that it might have some repercussions for the way in which companies finance their investments. Investment capital would be more costly for firms affected by the higher tax rates. Those firms would also be encouraged to increase their use of debt financing, the interest on which is tax-deductible, rather than issue stock. As a result, the higher level of debt could increase some companies' risk of bankruptcy.

RELATED OPTIONS: Revenue Options 25 and 30

Option 25

Integrate Corporate and Individual Income Taxes Using the Dividend-Exclusion Method

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	-26.6	-6.0	-16.5	-34.7	-23.6	-107.4	-374.5

Source: Joint Committee on Taxation.

Income generated by corporations is taxed in varying ways depending on the type of corporation and the form in which the income is paid. Some corporate income is taxed twice: first as profits under the corporate income tax and second as dividends and capital gains on corporate stock under the individual income tax. Other corporate income—such as interest on corporate bonds and the profits of companies that are not subject to the corporate tax (so-called S corporations, which are generally small and have few shareholders)—is subject only to the individual income tax. Still other corporate earnings are subject to taxation primarily under the corporate income tax and effectively have little or no tax imposed under the individual income tax—because taxes on capital gains on stock can be deferred until the gains are realized (when the stock is sold). Since investors face different effective tax rates depending on the organizational form of the business in which they are investing, the corporate and individual income taxes are said to be nonintegrated.

That lack of integration reduces economic efficiency (the relationship between total resources used and the social benefits they generate) by distorting various choices that companies make, such as:

- Whether to organize a business as a C corporation, which is subject to the corporate income tax, or as an S corporation or noncorporate entity (such as a partnership or proprietorship), neither of which faces the corporate tax;
- Whether to finance investment by borrowing funds or by issuing stock (unlike stock dividends, interest paid on debt is deducted from a corporation's income and thus reduces its taxes); and
- Whether to pay dividends to shareholders or reinvest earnings in the company (reinvested earnings increase the value of a corporation's stock, the gain from which is taxed only when the stock is sold).

In addition, the current nonintegrated system raises the overall taxation of income from capital, which distorts the choice that people make between saving and consuming. The lack of integration impairs economic efficiency, at a cost that has been estimated to equal about 0.25 percent to 0.75 percent of the value of total household consumption.

The individual and corporate income taxes could be integrated in various ways. All corporate earnings could be subject to the individual income tax (as the earnings of S corporations are); stock dividends and capital gains could be excluded from individual taxation; companies could be allowed to deduct dividends from corporate taxable income; or all business income could be subject to a tax at the corporate level, with no tax imposed on that income at the individual level.[1] Another approach, however—simply eliminating the corporate income tax without making other changes to the tax system—would continue to result in significant efficiency costs because stockholders would defer (or in some cases avoid altogether) paying taxes on corporate earnings that were not distributed as dividends.

This option would integrate the two income tax systems by changing the treatment of some dividends and capital gains. Specifically, individual taxpayers could exclude from their taxable income any dividends or capital gains that had already been taxed as profits at the corporate level—provided those dividends or gains resulted from earnings that the corporation received after this option took effect. (That change is identical to a proposal that was included in the President's budget for 2004.) In

1. For more information about alternative methods of integration, see Department of the Treasury, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (January 1992); and Alvin C. Warren Jr., *Integration of Individual and Corporate Income Taxes* (Philadelphia, Pa.: American Law Institute, 1993).

addition, the statutory tax rates on those dividends and capital gains that had not been taxed at the corporate level would immediately return to the rates that prevailed before they were lowered by the Jobs and Growth Tax Relief Reconciliation Act of 2003, or JGTRRA. (The current lower rates are scheduled to expire at the end of 2010.)

Together, the changes envisioned in this option would reduce revenues by a total of $107.4 billion over five years. Those changes would be permanent, unlike the current temporary rates on dividends and capital gains that they would replace. (The reduction in revenues from this option would be different if those lower rates were assumed to be permanent.)

The principal advantage of this option is that it would improve the integration of the corporate and individual income taxes. Under the current reduced tax rates on dividends and capital gains, some corporate profits are still subjected to additional taxation under the individual income tax. In addition, those tax rates apply regardless of whether profits distributed as dividends or realized as capital gains are taxed at the corporate level. Because of special provisions of tax law, not all corporate profits are taxed at the corporate level. Moreover, the reduced capital gains rates that were enacted in JGTRRA apply to gains not only on corporate stock but also on other assets. The effect of that broad scope is to worsen other distortions in the tax code—a situation that would not occur under this option. Furthermore, because JGTRRA's rate reductions are scheduled to expire after 2010, much of the potential gain in efficiency that integration could bring by reallocating capital might not be realized under current law.

The main disadvantages of this option are its complexity and administrative cost. To limit the amount of forgone revenue and to target the incentives of lower tax rates toward new investment, this option would not make all dividends and gains eligible for the exclusion, only those that resulted from earnings after the option was enacted. That restriction would require firms to maintain accounts and inform shareholders of the amounts of dividends and gains that they could exclude from their income—bookkeeping responsibilities that could prove burdensome. Moreover, although the lower rates enacted in JGTRRA did not represent a complete integration of the individual and corporate income taxes, they substantially reduced the differences that give rise to the distortions associated with the two taxes' lack of integration. Hence, simply making those lower rates permanent would achieve many of the same efficiency gains as full integration but with much less complexity. (See Revenue Option 3 for the costs of that approach.)

RELATED OPTIONS: Revenue Options 3, 4, 24, and 30

Option 26

Repeal the "Lower of Cost or Market" Inventory Valuation Method

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.6	+1.3	+1.3	+1.3	+0.9	+5.4	+6.5

Source: Joint Committee on Taxation.

Businesses that use the first-in, first-out approach to identify inventory receive a tax advantage under current law because they can employ the "lower of cost or market" (LCM) method of inventory valuation. That method allows firms to deduct from their taxable income unrealized year-end losses on items in their inventory that have declined in value. (The losses are unrealized because the items have not actually been sold.) For items that have increased in value, companies can defer taxes on unrealized gains until the year in which the items are sold. Similarly, goods in a firm's inventory that cannot be sold at normal prices because of damage, imperfections, or other problems qualify for the "subnormal goods" method of inventory valuation. That approach allows the company to immediately deduct the loss in value, even if it later sells those goods and realizes a profit on them.

This option would repeal the LCM and subnormal-goods methods of inventory valuation over a three-year period and require all firms to value their inventory according to its cost. (Under the cost method of inventory valuation, companies generally must include in taxable income both the gains and losses from any changes in the value of their inventory when the goods are sold.) Those changes would increase revenues by $0.6 billion in 2008 and by a total of $5.4 billion over the 2008–2012 period.

Inventory valuation is an integral part of determining a firm's taxable profits, which (in accounting terms) are the difference between the firm's receipts and the cost of the goods it has sold. Most businesses with an inventory are required to use the accrual method of accounting. Under that approach, a firm calculates the cost of the goods it has sold by adding the value of its inventory at the beginning of the year to the cost of goods it purchased or produced during the year and then subtracting from that total the value of its inventory at the end of the year. In valuing an inventory, companies may now use either the LCM method or the cost method; they can also use the subnormal-goods method for imperfect items that cannot be sold at regular prices, regardless of which inventory-valuation approach they choose.

The rationale for replacing LCM valuation with cost valuation is to eliminate the tax advantages that the LCM method provides. Under the LCM approach, a business compares the market value of each item in its inventory with the item's cost and then uses the lower of the two amounts as the item's value. A firm's inventory will have a lower total value under the LCM method than under the cost method if the market value of any item in the inventory is less than its cost. The reverse is not true, however, because under the LCM approach, inventory items that have appreciated in value during the year are pegged at their original cost. Thus, for a business that experiences both gains and losses from its inventory, the LCM method provides a tax advantage over the cost method by treating gains and losses asymmetrically (firms can recognize losses without counting comparable gains). As a result, a company may claim a deduction for certain losses in the value of its inventory even if, overall, the inventory's value has risen. In that way, the LCM method can increase the portion of the firm's costs that are tax-deductible in a given year and thus lower the firm's taxable profits.

The LCM method has two other features that may offer unwarranted tax advantages to the businesses that use it. First, once a company has reduced the value of its inventory, it is not required under current law to record an increase if the market value later rises. Second, market values under the LCM method are based on the replacement cost of inventory items, not on their resale value. Thus, that method allows a firm to reduce the value of items in its inventory if the items' replacement cost has declined—even though the firm may still be able to sell the items at a profit.

Companies that incur losses in the value of their inventory without offsetting gains would see a disadvantage in

repealing the LCM method of inventory valuation. For those businesses, the method provides a "cushion" during economic downturns or periods of uncertainty created by shifts in markets. A firm whose inventory has declined in value has incurred an economic loss. If that loss is deferred (not accounted for) until the inventory is subsequently sold, the company may be overtaxed.

Option 27

Tax Large Credit Unions in the Same Way as Other Thrift Institutions

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.2	+1.8	+1.9	+2.0	+2.1	+9.0	+21.1

Source: Joint Committee on Taxation.

Credit unions are nonprofit institutions that provide their members with financial services, such as accepting deposits and making loans. Originally, credit unions were designed to be cooperatives whose members shared a common bond (in most cases, the same employer or the same occupation). Partly as a result of that distinction, federal income tax law treats credit unions more favorably than competing thrift institutions—such as savings and loans and mutual savings banks—by not taxing their retained earnings (the portion of net income that they keep rather than paying out in dividends).

This option would tax the retained earnings of large credit unions—those with more than $10 million in assets—in the same way that the retained earnings of other thrift institutions are taxed. Credit unions with less than $10 million in assets, however, would continue to be tax-exempt. The change in the tax treatment of large credit unions would increase revenues by $1.2 billion in 2008 and by a total of $9.0 billion over five years.

Originally, the retained earnings of credit unions, savings and loans, and mutual savings banks were all exempt from taxation. In 1951, however, lawmakers eliminated the exemptions for savings and loans and mutual savings banks on the grounds that those institutions were similar to profit-seeking corporations. Since then, large credit unions have come to resemble other thrift institutions. Beginning in 1982, regulators have allowed credit unions to extend their services (with some limits) to members of organizations other than the ones for which they were founded. In addition, most credit unions permit members and their families to participate even after a member has left the sponsoring organization.

In part because of that relaxation of restrictions, total membership in credit unions has soared from about 5 million in 1950 to more than 85 million today. Large credit unions, like taxable thrift institutions, now serve the general public and provide many of the services offered by savings and loans and mutual savings banks—including mortgages and car loans, access to automatic tellers, credit cards, individual retirement accounts, and discount brokerage services. They also resemble thrift institutions in that they retain some of their earnings.

One argument for taxing the retained earnings of large credit unions like the earnings of other large thrift institutions is to improve economic efficiency. Taxing similar entities in a similar manner promotes competition and encourages them to provide services at the lowest cost. With their current tax advantage, credit unions can use their retained earnings to expand and thus displace the services of other thrift institutions, even though the latter may provide those services more efficiently.

Many credit unions, however, are more like cooperatives than like their larger counterparts, which suggests that their retained earnings should be treated similarly to those of other cooperatives. Like those entities, most small credit unions have members with a single common bond or association. And in some cases, their organizations are rudimentary: volunteers from the membership manage and staff the credit union, and the level of service is not comparable with that of other thrift institutions.

Allowing small credit unions to keep their tax exemption for retained earnings would affect about 3 percent of total assets in the credit union industry and about half of all credit unions. However, a problem with taxing the assets of large credit unions while allowing the assets of small ones to remain tax-exempt is that the $10 million threshold for determining a "large" credit union could be seen as arbitrary.

RELATED CBO PUBLICATION: *Taxing the Untaxed Business Sector,* July 2005

Option 28

Repeal the Expensing of Exploration and Development Costs for Extractive Industries

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+5.4	+7.2	+5.4	+3.7	+1.8	+23.5	+25.5

Source: Joint Committee on Taxation.

Through various tax incentives, the current tax system treats extractive industries—producers of oil, natural gas, and minerals—more favorably than most other industries. One incentive designed to encourage firms to explore for and develop certain types of oil, gas, and hard minerals allows producers to "expense" some of their exploration and development costs rather than capitalize them. In other words, companies are allowed to fully deduct those costs from taxable income when they are incurred rather than deduct them over time as the resulting income is generated.

In other industries, by contrast, costs must be deducted more slowly according to prescribed rates of depreciation or depletion. The Tax Reform Act of 1986 established uniform capitalization rules that require certain direct and indirect costs related to property to be either deducted when the property is sold or recovered over several years as depreciation (in either case, postponing those costs' deduction from taxable income). However, so-called intangible costs related to drilling and development (such as the maintaining of a working-capital fund) and costs for mine development and exploration are exempt from those rules. The ability to expense such costs gives extractive industries a tax advantage that other industries do not have.

This option would replace the expensing of exploration and development costs for oil, gas, and minerals with the standard capitalization approach. That change would increase revenues by $5.4 billion next year and by a total of $23.5 billion over five years. (Those amounts reflect the assumption that firms could still expense some of their costs, such as from unproductive wells and mines.)

The exploration and development costs that extractive companies can expense include costs for excavating mines, drilling wells, and prospecting for hard minerals—but not in the case of oil and natural gas. Current law allows independent oil and gas producers and noncorporate mineral producers to fully expense their costs. However, for "integrated" oil and gas producers (companies involved in substantial retailing or refining activities) and for corporate mineral producers, expensing is limited to 70 percent of costs. Those firms must deduct the remaining 30 percent of their costs over 60 months.

The primary rationale for this option is that expensing distorts how society's resources are allocated in several ways. First, it causes resources to be used for drilling and mining that might be employed more productively elsewhere in the economy. Second, it may influence the way in which resources are allocated within the extractive industries. Firms may decide what to produce not on the basis of factors related to economic productivity but on the basis of the size of the advantage that expensing provides (for example, the difference between the immediate deduction and the deduction over time, which reflects the true useful life of the capital involved.) Such decisions may also rest on whether the producer must pay the alternative minimum tax, under which expensing is limited. Third, expensing encourages producers to extract more resources now—which, in the short run, could make the United States less dependent on imported oil but, in the long run, could mean that the nation would have less oil available to extract and thus might have to rely more on foreign producers.

The rationale for expensing the costs of exploration and development has shifted over time. When the current incentive was put in place, its advocates argued that those costs were ordinary operating expenses. Today, they also argue that oil and natural gas are strategic resources that are essential to the nation's energy security.

RELATED OPTIONS: 300-5, 300-7, and Revenue Option 56

RELATED CBO PUBLICATION: *Reforming the Federal Royalty Program for Oil and Gas,* November 2000

Option 29

Tax the Income Earned by Public Electric Power Utilities

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.5	+0.8	+0.8	+0.8	+0.9	+3.8	+8.6

Source: Joint Committee on Taxation.

In the United States, some electricity is provided by privately owned companies and some by public utilities owned by local governments. The income that those governments earn from any public utility, including electric power facilities, is exempt from federal income taxes. By contrast, the income of investor-owned utilities is taxable.

This option would tax the income of public facilities that generate, transmit, or distribute electricity. That change would increase federal revenues by $0.5 billion in 2008 and by a total of $3.8 billion through 2012.

In the past, local monopolies provided electricity, in part to take advantage of cost-saving economies of scale. Some of those utilities were public facilities, which had developed for various reasons. For example, public utilities offered a feasible alternative in places where low population density made the cost of power per customer high and private producers were reluctant to enter the market because the potential for profit appeared inadequate. Public utilities also developed in areas where residents—worrying that a private provider might exploit its position as a monopoly—wanted to ensure that electricity would be available to all households at a reasonable cost. Now, however, states are in varying stages of deregulating electricity generation, partly because improved technologies have lessened the importance of economies of scale and partly because electricity service is almost universal in the United States, even in areas with few people.

The major argument for taxing the income earned by public electric utilities is that the recent changes in the electricity market cast doubt on the benefits that society receives from the public sector's involvement in providing electricity. The private sector already supplies about three-quarters of the nation's electric power. Advocates of this option argue that the competition that is resulting from the industry's restructuring will protect consumers from monopolistic pricing by private firms. (California's experience in 2000 and 2001, however, suggests that some degree of government oversight of the market may still be needed.) Other rationales for ending the favorable tax treatment of publicly owned power facilities might be to further boost competition, to encourage the consumption of an economically efficient amount of publicly provided electricity, and to preserve the corporate tax base.

One argument against this option is that exempting the income of public utilities from taxation keeps the price of power low and thus reduces the amount that lower-income people pay for electricity. In addition, taxing the income of public electric utilities might adversely affect residents of some communities that rely on such facilities for their power. Taxation would cause the price of publicly provided electricity to rise, and public utilities that found themselves uncompetitive might have to shut down facilities that were inefficient. If those facilities were being financed with debt that had not yet been retired, state and local taxpayers could be left with significant costs. Another complication associated with this option is that numerous legal and practical issues would have to be resolved if the federal government taxed income earned from what might be termed business enterprises of state and local governments.

RELATED OPTIONS: 270-10, 270-11, 270-12, and Revenue Option 33

RELATED CBO PUBLICATIONS: *Prospects for Distributed Electricity Generation,* September 2003; and *Causes and Lessons of the California Electricity Crisis,* September 2001

Option 30

Repeal Tax-Free Conversions of Large C Corporations to S Corporations

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	*	*	*	*	+0.1	+0.1	+2.2

Source: Joint Committee on Taxation.

Note: * = between zero and $50 million.

Businesses can be structured in various ways, each of which has different implications for the tax liability of the entity and its owners and for the owners' legal liability. For tax purposes, the main forms of business enterprise are C corporations, S corporations, partnerships, and sole proprietorships. Companies whose stock trades publicly are usually C corporations, although many small, privately owned businesses are also structured in that way. The income of a C corporation faces a two-tiered tax: The firm's net income and capital gains are taxed at the corporate level, and when the firm distributes its after-tax profits to shareholders as dividends, those dividends are subject to the individual income tax. The owners of a C corporation are not legally liable for the actions of the corporation.

By contrast, businesses such as partnerships, sole proprietorships, and S corporations are set up in a "flow-through" structure. Income and expenses pass through the business to the shareholders (in the case of an S corporation) or to the partners or proprietors (in the case of partnerships and sole proprietorships), and the income is generally free from corporate income taxes. But shareholders, partners, and proprietors pay tax on that income under the individual income tax, even if the income is reinvested in the business.

S corporations differ from the other two kinds of flow-through firms in part by legal liability. Owners of S corporations—unlike sole proprietors or partners in limited or general partnerships—have limited liability. They face many restrictions, however: for example, S corporations may have no more than 100 owners, and they may not have C corporations as shareholders. Until recently, S corporations were the only type of business that offered owners both limited liability and a form of tax treatment that placed business income and losses under the individual income tax. In 1988, the Internal Revenue Service ruled that limited liability companies, or LLCs, which are defined under state law, could be treated as partnerships for federal tax purposes (though with some restrictions). Over time, the distinction between S corporations and partnerships has blurred.

Under current law, a C corporation can reduce tax liability on some of its income by converting to an S corporation or a partnership. Between those alternatives, the tax code provides an incentive to choose the S corporate structure because converting to an S corporation is tax-free in many circumstances. Converting to a partnership, by contrast, is taxable; it requires the corporation to "recognize" (include in its taxable income) any built-in gain on its assets and requires the company's shareholders to recognize any such gain in their corporate stock. Under section 1374 of the Internal Revenue Code, if a C corporation converts to an S corporation, the appreciation of the firm's assets while it was a C corporation is not subject to corporate income taxes, unless the assets are sold within 10 years of the conversion. Thus, current law allows a C corporation to avoid two-tiered taxation by converting tax-free to an S corporation.

This option would repeal such tax-free conversions for C corporations whose value was greater than $5 million at the time of the conversion. That is, when a C corporation with a value of more than $5 million converted to an S corporation, the company and its shareholders would immediately recognize the gain on their appreciated assets. Taxing such conversions would increase income tax revenues by a total of $0.1 billion over five years but by $2.2 billion through 2017.

A major advantage of this option is that repealing tax-free conversions by C corporations would treat economically similar conversions—from two-tiered corporate tax systems to single-tiered systems—in the same way. Equalizing that tax treatment would, in turn, allow society's resources to be allocated more efficiently by making tax

considerations less important in decisions about what legal form a business should take.

An argument against changing the current differential tax treatment is that, in some people's eyes, S corporations resemble C corporations more closely than they do partnerships. In that view, current law merely allows a C corporation (if it meets the legal requirements) to choose a different corporate form—that of an S corporation—and change its filing status without having to pay tax.

RELATED OPTIONS: Revenue Options 24, 25, and 44

Option 31

Repeal the Low-Income Housing Credit

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.1	+0.4	+0.9	+1.5	+2.1	+5.0	+26.1

Source: Joint Committee on Taxation.

The low-income housing credit (LIHC) subsidizes the construction, substantial rehabilitation, or purchase of buildings that are used to provide rental housing to people with low income. Corporations and individuals that qualify for the LIHC receive tax credits over a 10-year period that can be worth as much as 70 percent of a building's construction or rehabilitation costs or 30 percent of its purchase price. The majority of qualifying projects are new construction.

To qualify for the LIHC, the owners of a project must fulfill several requirements. They must set aside at least 20 percent of a building's rental units for families whose income is below 50 percent of the median income in the area or 40 percent of the units for families whose income is below 60 percent of the median. In addition, rents for those units are restricted. The set-aside requirements and the limits on rents apply for at least 30 years. Unlike most tax provisions, however, the LIHC is not necessarily available once its requirements have been met. The credit is limited by statute and allocated by state housing authorities, which are authorized to issue a fixed number of credits depending on the state's population.

This option would repeal the LIHC for new projects to build, renovate, or purchase low-income housing. (The credit would continue for previously approved projects that had time remaining on their 10-year periods.) That change would increase revenues by $0.1 billion in 2008 and by $5.0 billion through 2012.

An argument for eliminating the credit is that, in most places, federal housing vouchers could assist the same number of people at a lower cost. Low-income tenants can use such vouchers to pay all or part of the rent for the housing of their choice (as long as the dwelling meets minimum standards for habitability). In most cases, housing vouchers are more likely than tax credits to help low-income people obtain rental housing, because the existing stock of buildings can usually provide adequate housing more affordably than either new construction or buildings that have been substantially rehabilitated. Extra overhead costs (such as for additional paperwork and approvals) also make some housing that is subsidized by the LIHC more expensive to produce and rent.

Another rationale for repealing the credit is that it does not, by itself, always fulfill the purpose that it was designed to serve. In general, households with the lowest income do not rent units whose construction or rehabilitation has been supported by the LIHC unless they or the project receive additional subsidies. Rather, the credit tends to benefit lower-middle-income people whose income typically is too high to allow them to qualify for voucher and public housing programs.

An argument for retaining the credit is that, in some neighborhoods, existing housing that meets minimum standards for habitability at affordable rents is scarce. Furthermore, the money spent to build new housing and rehabilitate existing dwellings may help revitalize neighborhoods. In contrast, similar spending on housing vouchers is unlikely to have a noticeable impact on a neighborhood, because the vouchers' effect is more likely to be diluted among a number of neighborhoods.

RELATED OPTIONS: 600-6 and 600-7

Option 32

Extend the Period for Recovering the Cost of Equipment Purchases

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+4.2	+12.9	+19.5	+22.2	+24.6	+83.4	+192.5

Source: Joint Committee on Taxation.

When a company calculates its taxable income, it is allowed to deduct many of the expenses that it incurs to produce the goods and services it sells. One of those deductible expenses is depreciation (the drop in the value of productive assets over time). For taxable income to be calculated accurately, deductions for depreciation should reflect an asset's actual economic decline—that is, economic depreciation, which takes into account inflation over the lifetime of the asset. However, rates of depreciation are set by the tax code, and depreciation deductions are not indexed for inflation. As a result, the real (inflation-adjusted) value of the depreciation allowed by tax law depends on the rate of inflation.

The Tax Reform Act of 1986 is the major source of the current rates of depreciation for tax purposes, which were set to approximate economic depreciation with inflation of 5 percent. Yet, in the Congressional Budget Office's estimation, the inflation that will apply to economic depreciation over the coming decade will average about 2 percent. That estimated difference of 3 percentage points means that tax depreciation is more valuable than economic depreciation, resulting in the understatement of firms' taxable income.

Two of the main types of tangible capital for which firms take depreciation deductions are equipment and structures. Depreciation deductions for equipment tend to contribute more to the understatement of taxable income than deductions for structures do. The reason is that equipment has a shorter service life (the time over which depreciation deductions can be taken); thus, changes in inflation affect deductions for equipment more strongly than deductions for structures. In addition, since 1986, policymakers have extended the useful lifetimes of some kinds of structures for calculating depreciation.

This option would lengthen the lifetime of equipment for tax depreciation purposes. Specifically, property that currently has a lifetime of 3, 5, 7, 10, 15, or 20 years under the tax code would shift to a lifetime of 4, 8, 11, 20, 30, or 39 years, respectively. Those changes would increase revenues by $4.2 billion in 2008 and by a total of $83.4 billion over five years.

One advantage of this option is that it would equalize effective tax rates on different types of investment. Under the assumptions of 2 percent inflation and a 7 percent real discount rate (to adjust for the change in the worth of a dollar over time), the average effective tax rate on equipment for all firms would be about 32.9 percent, and the rate on structures would be 33 percent. That near parity would lessen the tax code's current incentive for companies to invest more in equipment and less in structures than they would if investment decisions were based on economic returns. Such a tax incentive distorts firms' choices between investing in equipment and investing in structures, thus reducing the efficiency of the economy.

Those average tax rates would differ with different inflation rates, however. If inflation was half a percentage point lower, the rates would be 32 percent for equipment and about 32.5 percent for structures. Conversely, if inflation was half a percentage point higher, the effective tax rates on equipment and structures would be 33.8 percent and 33.5 percent, respectively. Therefore, if inflation differed from CBO's expectations, new distortions would emerge over the long run between investment in equipment and structures.

Some opponents of this option argue that low tax rates on capital are important for maintaining a strong economy. Others favor equalizing the current tax treatment by easing the taxation on all forms of capital rather than by raising the effective tax rate on a type of capital that is now favored. In addition, under this option, there would continue to be substantial variation in the effective tax rates on different types of equipment.

RELATED CBO PUBLICATIONS: *Computing Effective Tax Rates on Capital Income,* December 2006; and *Taxing Capital Income: Effective Rates and Approaches to Reform,* November 2005

Option 33

Eliminate or Limit Tax-Exempt Private-Activity Bonds

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues							
Eliminate tax exemption for new bonds	+0.1	+0.5	+1.1	+1.7	+2.3	+5.7	+25.6
Eliminate indexation of the volume cap	*	*	*	*	+0.1	+0.2	+1.7

Source: Joint Committee on Taxation.

Note: * = between zero and $50 million.

Federal tax law permits state and local governments to issue bonds whose interest income is exempt from federal taxation. As a result, those bonds bear lower rates of interest than they would if the interest income were taxable. (The bondholder is compensated for the lower interest rate by not having to paying federal tax on the interest income.) For the most part, proceeds from those tax-exempt bonds finance public projects, such as schools, highways, and water and sewer systems. But state and local governments also issue tax-exempt securities—known as private-activity bonds—whose proceeds are used by nongovernmental entities to finance various quasipublic facilities and private-sector projects: mortgages for rental housing and single-family homes; infrastructure facilities such as airports, docks, wharves, mass transit, and solid-waste disposal plants; small manufacturing plants and agricultural land and property for first-time farmers; student loans; and facilities for nonprofit institutions, such as hospitals and universities.

The Tax Reform Act of 1986 limits the annual volume of new bonds that state and local governments can issue for eligible facilities, small manufacturing plants, student loans, and housing and redevelopment projects. Some private-activity bonds are exempt from the volume cap, including those for airports, ports, and solid-waste disposal facilities that meet requirements for government ownership, as well as certain bonds for nonprofit organizations (primarily hospitals and educational institutions). Initially, the cap was not indexed for inflation, so the volume of private-activity bonds issued each year would decline over time and eventually disappear. However, the volume cap has since been raised periodically, and it was indexed for inflation beginning in 2002. (At that time, the annual volume of new bonds allowed was $225 million or $75 per resident, whichever was greater.)

This option would curtail the issuance of private-activity bonds either by eliminating the tax exemption for all new issues or by allowing tax exemption but no longer indexing the volume cap for inflation. The first approach would have an immediate impact on the volume of such bonds and would increase revenues by a total of $5.7 billion over the 2008–2012 period. The second approach would work more slowly, boosting revenues by only $0.2 billion over those five years. (Lawmakers could also limit the outstanding stock of private-activity bonds for certain uses, such as nonprofit organizations' facilities. That change is discussed in the next option.)

An advantage of this option is that eliminating or limiting the tax exemption for new private-activity bonds would improve economic efficiency. Investments that can be financed at below-market interest rates require a lower return and thus contribute less to national income than do investments that are not preferentially taxed. Altering those projects' financing by removing the tax exemption or curbing the volume cap would redirect savings to more valuable uses and allocate resources more efficiently.

A disadvantage of this option is that state and local governments and other entities that rely on private-activity bonds would face higher costs to finance projects that benefit their communities. (If the federal government wished to help such projects, however, it could do so more efficiently through a direct subsidy. Unlike

tax-exempt financing, such a subsidy would not reduce federal revenues by more than the drop in borrowers' interest costs. In addition, access to a direct subsidy would not be open ended, and the subsidy amount could receive regular scrutiny from lawmakers in the annual appropriation process.)

RELATED OPTIONS: Revenue Options 21 and 34

RELATED CBO PUBLICATIONS: *Nonprofit Hospitals and Tax Arbitrage,* December 2006; *Nonprofit Hospitals and the Provision of Community Benefits,* December 2006; *Testimony on Economic Issues in the Use of Tax-Preferred Bond Financing,* March 16, 2006; and *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures,* July 2004

Option 34

Cap Nonprofit Organizations' Outstanding Stock of Tax-Exempt Bonds

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	*	*	*	+0.1	+0.2	+0.5	+2.7

Source: Joint Committee on Taxation.

Note: * = between zero and $50 million.

Under current law, the interest income that investors earn on bonds issued by state and local governments is exempt from federal taxation. That tax exemption means that such bonds can pay below-market interest rates and still attract investors. In general, the proceeds that state and local governments receive from issuing tax-exempt bonds are used to finance schools, highways, and other public infrastructure projects. But states and localities can also issue tax-exempt "private-activity" bonds, whose proceeds are used to finance a wide range of quasipublic or private-sector projects, including facilities for nonprofit institutions such as hospitals and universities.

The Tax Reform Act of 1986 limited the annual volume of new tax-exempt bonds that could be issued for many, though not all, private activities. Nonprofit institutions were not included in that annual cap, but a $150 million ceiling was imposed on each institution's outstanding stock of tax-exempt bonds (excluding those of hospitals). That $150 million ceiling was eliminated in 1997.

This option would reestablish the $150 million cap on the outstanding stock of tax-exempt bonds that a nonprofit organization—including a nonprofit hospital—could use for financing. That cap would increase federal tax revenues by a total of $0.5 billion through 2012. (A related approach, ending or reducing the tax exemption for new issues of private-activity bonds, is discussed in the previous option.)

An advantage of limiting nonprofit organizations' tax-exempt bond financing is that it would curtail what might be characterized as arbitrage profits that such organizations can earn indirectly under the current system. Many nonprofit universities, hospitals, and other institutions use tax-exempt debt to pay for buildings and equipment that they could have financed by selling their own investment assets. Their decision to fund new operating assets with tax-exempt bonds is influenced by their ability to earn an untaxed return from their investment assets that is much higher than the interest cost they must pay on the bonds—in other words, arbitrage profits. Imposing a ceiling on such organizations' outstanding stock of tax-exempt bonds would curtail that tax arbitrage. Investment might be redirected to more valuable uses because projects that would otherwise be financed with tax-exempt debt would be forced to compete for funding at the higher interest rate prevailing in private markets.

A drawback of such a ceiling is that some of the nonprofit activities that would face higher financing costs under this option might be activities that provide enough public benefits to justify a tax subsidy.

RELATED OPTIONS: Revenue Options 21 and 33

RELATED CBO PUBLICATIONS: *Nonprofit Hospitals and Tax Arbitrage,* December 2006; *Nonprofit Hospitals and the Provision of Community Benefits,* December 2006; *Testimony on Economic Issues in the Use of Tax-Preferred Bond Financing,* March 16, 2006; and *Tax-Credit Bonds and the Federal Cost of Financing Public Expenditures,* July 2004

Option 35

Repeal the Deduction for Domestic Production Activities

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+3.2	+7.5	+9.6	+11.8	+12.6	+44.7	+119.8

Source: Joint Committee on Taxation.

Under the American Jobs Creation Act of 2004, businesses can deduct from taxable income a percentage of what they earn from qualified domestic production activities. The deductible percentage was set at 3 percent for taxable years beginning in calendar years 2005 and 2006; it rises to 6 percent for taxable years beginning in 2007 through 2009, and to 9 percent thereafter. Various activities qualify for the deduction, including:

- Lease, rental, sale, exchange, or other disposal of tangible personal property, computer software, or sound recordings, if they are manufactured, produced, grown, or extracted in whole or significant part in the United States;
- Production of films (other than sexually explicit ones);
- Production of electricity, natural gas, or potable water;
- Construction or renovation; and
- Performance of engineering or architectural services.

Qualified activities specifically exclude the sale of food or beverages prepared at retail establishments; the transmission or distribution of electricity, natural gas, or potable water; and many activities that would otherwise qualify except that the proceeds come from sales to a related business.

The deduction for domestic production activities was created in part to replace the tax code's extraterritorial income exclusion—which, according to the World Trade Organization (WTO), violated WTO agreements by subsidizing exports. The deduction was intended to reduce the taxes on income from domestic production without violating the WTO's rules.

This option would repeal the deduction for domestic production activities. Doing so would raise revenues by $3.2 billion in 2008 and by a total of $44.7 billion over the 2008–2012 period.

One rationale for eliminating the deduction is that it creates economic distortions. Although it is targeted toward investments in domestic production activities, it does not apply to all domestic production. Whether a business activity qualifies for the deduction is unrelated to the economic merits of the activity. Thus, the deduction gives businesses an incentive to invest in a particular set of domestic production activities and to forgo other, perhaps more economically beneficial investments in domestic production activities that do not qualify.

In addition, to comply with the law, businesses must satisfy a complex and evolving set of statutory and regulatory rules about how to allocate gross receipts and business expenses to the qualified activities. The complexity of those rules and the costly planning that companies will have to engage in to take full advantage of the deduction are likely to cause controversies between businesses and the Internal Revenue Service. Yet more rules will be needed to address those controversies.

An argument against this option is that simply repealing the deduction for domestic production activities would increase the cost of domestic business investment. Alternatively, the deduction could be replaced with a revenue-neutral cut in the top corporate tax rate (a cut that would reduce revenues by the same amount that eliminating the deduction would increase them). That alternative would end the current distortions between activities that qualify for the deduction and those that do not. It would also reduce biases in the corporate tax that favor noncorporate investments over investments in the corporate sector and foreign business activities over domestic ones.

Option 36

Permanently Extend the Research and Experimentation Tax Credit

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	-2.6	-4.9	-6.1	-7.4	-8.7	-29.7	-84.9

Source: Joint Committee on Taxation.

Current law allows businesses to take a nonrefundable research and experimentation (R&E) tax credit equal to 20 percent of their qualified research expenses above a base amount. That base amount is generally determined by multiplying a company's average annual gross receipts in the previous four years by its ratio of research expenses to gross receipts during the 1984–1988 period. Companies that did not exist at that time are assigned a fixed ratio (research expenses to gross receipts) of 3 percent. As an alternative, businesses can choose to apply a much lower credit rate (ranging from 2.65 percent to 3.75 percent) to qualified research expenses in excess of a lower base amount (ranging from 1 percent to 2 percent of average gross receipts).

The R&E tax credit was first enacted as a temporary provision in the Economic Recovery Tax Act of 1981. It has been extended, with modifications, 10 times since then. Each extension has been fully retroactive to the previous date of expiration (except for one year between June 30, 1995, and July 1, 1996). Most recently, the credit expired on December 31, 2005, and was later retroactively extended until January 1, 2008.

This option would make the research and experimentation tax credit permanent. That change would reduce revenues by $2.6 billion in 2008 and by a total of $29.7 billion over five years.

Supporters of the R&E credit argue that the tax provision produces a net benefit for society by making it cheaper for companies to engage in types of research that create general knowledge or other social benefits beyond those that accrue to the firms themselves. In that view, encouraging such research can make the economy as a whole more productive than it would be otherwise.

According to supporters, those benefits would probably increase if the credit was no longer allowed to expire every few years. A temporary tax credit creates uncertainty about whether and when it will be extended and with what modifications. Such uncertainty is not likely to matter much in the case of qualified research projects that take only a short time to complete. But making the tax credit permanent might encourage longer-term research projects by decreasing businesses' uncertainty about the costs of undertaking those projects. Because a permanent extension would probably shift the incentives toward such longer-term projects, it would shift the incentives toward research for which the effect of the credit is most likely to produce a net social gain.

An argument against permanently reinstating the R&E tax credit is that the credit could make the economy less productive by encouraging firms to pursue some research that does not provide social benefits in addition to private benefits. In cases in which there are no additional social benefits, the tax credit merely gives companies an incentive to undertake research projects that qualify for the credit rather than make alternative investments that would otherwise earn a higher return. Whether the R&E tax credit produces a net benefit to the economy depends on the extent to which it encourages research that imparts general knowledge or other social benefits. The evidence on that question is inconclusive.

RELATED CBO PUBLICATION: *R&D and Productivity Growth,* June 2005

Option 37

Tax the Federal Home Loan Banks Under the Corporate Income Tax

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.7	+1.1	+1.2	+1.2	+1.5	+5.7	+15.1

Source: Joint Committee on Taxation.

The Federal Home Loan Bank (FHLB) System is a government-sponsored enterprise (GSE) that was created in 1932 to provide low-cost loans (called advances) to thrift institutions to bolster their lending for home mortgages. The system consists of 12 banks that are cooperatively owned by their members, mainly commercial banks and thrifts. The FHLBs raise money in the capital markets through borrowing to fund the advances made to members. Because investors perceive an implied guarantee of the FHLBs' debt by the federal government, the banks are able to borrow at rates below those available to private entities. In recent years, the FHLBs have also started purchasing mortgages from their members, which puts them in direct but limited competition with Fannie Mae and Freddie Mac, the other housing GSEs.

In contrast to the other GSEs that finance home mortgages, the FHLBs pay no federal corporate income taxes. The federal government requires them to make other payments, however. They must devote 10 percent of their previous year's net income to affordable-housing programs, which offer subsidized and other low-cost funding to targeted borrowers. In 2005, the FHLBs' payments for affordable housing totaled $280 million. The programs subsidized the rental or purchase of over 430,000 housing units for low- and moderate-income borrowers from 1990 to 2004. The FHLBs are also required to transfer 20 percent of their net income to the Resolution Funding Corporation (REFCORP), a federal corporation created to borrow money to help finance the Federal Savings and Loan Insurance Corporation's obligations for insured deposits of insolvent thrifts. The banks' payments totaled $498 million in 2005. The FHLBs are projected to make their last contributions to REFCORP for its debt service in 2011. (Their total contributions to REFCORP are capped by law.) Both types of required payments are included as revenues in the federal budget.

This option would impose federal corporate income taxes on the FHLBs. Taxing the FHLBs would generate revenues of $0.7 billion in 2008 and $5.7 billion over five years. Those estimates assume that the FHLBs' payments for affordable housing and REFCORP would be deductible expenses for the purpose of calculating federal income taxes. (Revenues would be significantly lower if tax credits were granted for either or both types of required payments.)

An advantage of this option is that it would eliminate a special privilege—tax-free status—not provided to other entities (including Fannie Mae and Freddie Mac) and not wholly benefiting mortgage borrowers. Studies by the Congressional Budget Office and others have concluded that the FHLB system's status as a government-sponsored enterprise confers substantial implicit federal subsidies beyond the tax benefits, which are not fully passed on to mortgage borrowers.

A disadvantage of the option is that it might cause member banks to pay somewhat higher costs for their advances, which could result in higher costs to borrowers. Another disadvantage is that taxing the FHLBs while also requiring payments to affordable-housing programs and REFCORP could create a greater burden than is imposed on their competitors. If so, the banks might be less able compete with Fannie Mae and Freddie Mac.

RELATED OPTIONS: 370-7 and Revenue Option 65

RELATED CBO PUBLICATIONS: *Updated Estimates of the Subsidies to the Housing GSEs,* April 8, 2004; *Federal Subsidies and the Housing GSEs,* May 2001; and *The Federal Home Loan Banks in the Housing Finance System,* July 1993

Option 38

Expand the Medicare Payroll Tax to Include All State and Local Government Employees

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.6	+0.7	+0.6	+0.5	+0.3	+2.7	+3.3

Source: Joint Committee on Taxation.

Unlike nearly all private-sector workers and federal employees, certain workers employed by state or local governments do not pay the Medicare payroll tax. That tax is currently 2.9 percent of earnings, half of which is deducted from employees' paychecks and half of which is paid by employers. The Consolidated Omnibus Budget Reconciliation Act of 1985 mandated that employees who began working for a state or local government after March 31, 1986, pay the Medicare tax, but it did not make the tax mandatory for workers hired before that date. Under the Omnibus Budget Reconciliation Act of 1990, the tax's reach was broadened to include all state and local government workers who were not covered by a retirement plan through their current employer.

This option would impose the Medicare tax on all state and local government employees who do not now pay it, increasing revenues by $0.6 billion in 2008 and by a total of $2.7 billion over the 2008–2012 period. The annual gain in revenues from that change would decline over time as employees who were hired before April 1986 gradually retired or otherwise left the payrolls of state and local governments.

Paying the Medicare payroll tax for 10 years generally qualifies workers (and their spouses) to receive Medicare benefits when they reach age 65 or become disabled. Thus, extending the tax to more employees would eventually increase the number of Medicare beneficiaries. That addition would have a relatively small impact on Medicare spending, however. (The estimates shown here do not reflect those additional outlays.)

A rationale for requiring all state and local government employees to pay the Medicare payroll tax is fairness. Only about 10 percent of state or local workers do not currently pay the tax through their employers; nevertheless, most of those workers will receive Medicare benefits under current law because they either had other, covered jobs in the past or are covered through their spouse's employment. The broader coverage created by this option would lessen the inequity of those employees' receiving high levels of benefits in relation to the payroll taxes they paid.

One drawback of expanding Medicare coverage to all state and local government employees is that the federal government's obligation for future benefits under the program would increase. In addition, that change could affect the finances of some state and local governments that have large numbers of workers who are not currently covered by Medicare.

Option 39

Increase the Maximum Taxable Earnings for the Social Security Payroll Tax

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues							
Tax 92 percent of earnings	+18.8	+62.5	+65.6	+67.8	+70.0	+284.7	+682.7
Tax 91 percent of earnings	+17.9	+55.5	+58.2	+60.0	+61.9	+253.5	+604.3
Tax 90 percent of earnings	+16.5	+48.3	+50.5	+52.1	+53.7	+221.1	+524.4

Source: Joint Committee on Taxation.

Social Security—which is composed of the Old-Age, Survivors, and Disability Insurance (OASDI) programs—is financed by a payroll tax on employees, employers, and self-employed people. Only earnings up to a specified maximum are subject to the tax. That maximum, which is $97,500 in 2007, automatically increases each year by the growth rate of average wages in the economy.

When Social Security began in 1937, about 92 percent of the total earnings from jobs covered by the program were below the maximum taxable amount. That percentage gradually declined over time because the maximum was raised only occasionally, when lawmakers enacted specific increases to it. The 1977 amendments to the Social Security Act boosted the percentage of covered earnings subject to the tax to 90 percent by 1982; that law also provided for the taxable maximum to rise automatically each year with the growth in average wages. Despite that indexing, the overall fraction of earnings that is taxable has slipped in the past decade because earnings for the highest-paid workers have grown faster than the average. Thus, in 2005, approximately 85 percent of earnings from employment covered by OASDI fell below the maximum taxable amount.

This option would increase the share of total earnings subject to the Social Security payroll tax to 92 percent, 91 percent, or 90 percent by raising the maximum taxable amount to $250,000, $214,000, or $186,000, respectively. After that increase, the maximum amount would continue to be indexed as it is now.

The first alternative, 92 percent coverage, would generate an additional $284.7 billion in revenues over the 2008–2012 period; the second, 91 percent coverage, would increase revenues by $253.5 billion in that period; and the third, 90 percent coverage, would add $221.1 billion to revenues over those five years. However, because the Social Security benefits that retirees receive are tied to the amount of taxes they pay, some of the increase in revenues from this option would be offset by the additional retirement benefits that Social Security would pay to people with income above the current maximum taxable amount. The revenue estimates shown here do not reflect those additional outlays (although they include the effects on individual income tax revenues that result from assumed changes in the taxable and nontaxable components of labor compensation).

Besides improving the Social Security system's long-term financial outlook, this option would make the payroll tax less regressive. Because people who have income above the ceiling do not pay the tax on all of their earnings, they pay a smaller fraction of their total income in payroll taxes than do people whose total earnings are less than the maximum amount. Making more earnings taxable would increase payroll taxes for those high-income earners and move the Social Security tax toward proportionality. (Although that change could also lead to higher benefit payments for people with earnings above the prior maximum, the additional benefits would be modest relative to the additional taxes those earners would have to pay.)

A drawback of this option is that raising the earnings cap could weaken the link between the taxes that workers pay into the system and the benefits they receive, which has been an important aspect of the Social Security system since its inception. Moreover, this option would reduce the rewards of working for people with earnings above

the current maximum by subjecting those earnings to the Social Security tax, which would raise their average tax rate. As a result, such earners would have an incentive to work less or to take more compensation in the form of fringe benefits that would not be subject to payroll taxes.

RELATED CBO PUBLICATIONS: *Is Social Security Progressive?* December 15, 2006; *Updated Long-Term Projections for Social Security,* June 2006; *The Long-Term Budget Outlook,* December 2005; and *Social Security: A Primer,* September 2001

Option 40

Calculate Taxable Wages in the Same Way for Self-Employed People and Employees

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues							
On-budget	+0.2	+0.3	+0.3	+0.3	+0.3	+1.4	+2.9
Off-budget	+0.1	+0.1	+0.2	+0.2	+0.2	+0.8	+1.6

Source: Joint Committee on Taxation.

Social Security and Medicare taxes come in two forms: the Federal Insurance Contribution Act (FICA) tax paid on wages, and the Self-Employment Contribution Act (SECA) tax paid on income from self-employment. Under FICA, employees and employers each pay a Social Security tax of 6.2 percent on wages up to a maximum taxable amount ($97,500 in 2007) as well as a Medicare tax of 1.45 percent on all wages. Until 1983, the tax rate levied on income from self-employment (the SECA rate) was lower than the combined employer and employee rate under FICA. As part of the Social Security Amendments of 1983, however, lawmakers increased the effective tax rate under SECA. The report of the conference committee for that law said the change was "designed to achieve parity between employees and the self-employed" beginning in 1990.

In fact, the current method for calculating SECA taxes allows a self-employed person to pay less tax than a worker with the same nominal income who is not self-employed, in two ways. First, under current law, self-employed people calculate their tax on an income base that comprises their total compensation minus 7.65 percent; for other workers, tax is calculated on total compensation without a percentage deduction. For example, an employee who earns $50,000 pays $3,825 in FICA taxes, which are calculated on a taxable base of $50,000; his or her employer also pays $3,825 in FICA taxes. Because the employer's contribution amounts to additional compensation, the employee is implicitly earning $53,825 ($50,000 plus the employer's share of FICA taxes) and paying $7,650 in employment taxes.[1] An otherwise identical worker who is self-employed and earning the same $53,825 pays $7,605 in SECA taxes ($53,825 minus 7.65 percent, times the SECA rate), or $45 less. The difference arises because comparability would require that the 7.65 percent tax rate be applied to a base of $50,000 for self-employed people, not $49,707.

Second, among people with earnings above Social Security's taxable maximum, those who are self-employed pay the same amount of Social Security tax as employees—the tax on $97,500—but pay less Medicare tax. For example, an employee who earns $100,000 and his or her employer each pay the maximum amount of Social Security tax ($6,045) as well as $1,450 in Medicare tax. The employee's total compensation is thus $107,495, and the total FICA tax is $14,990. That person's self-employed counterpart who earns $107,495, however, has a taxable base of $99,272 (total compensation of $107,495 minus 7.65 percent). Consequently, the self-employed worker pays the same maximum Social Security tax but $21 less in Medicare tax. Indeed, high-income self-employed taxpayers may pay as much as 6.3 percent less in Medicare tax under SECA than employees with similar total compensation pay under FICA. That difference has existed since 1991, when lawmakers first set a taxable maximum for Medicare that was higher than the taxable maximum for Social Security. (The cap on taxable earnings for the Medicare tax ended in 1994.)

This option would eliminate the difference between the way wages subject to payroll taxes are calculated for self-employed people and the way they are determined for employees. Changing the calculation of taxable wages for SECA taxes would increase on-budget revenues by a total

1. Total compensation is generally defined as including not only wages but also other financial benefits that a worker receives, such as health or life insurance premiums paid by an employer, vacation and sick leave, the subsidized value of benefits such as child care facilities, and taxes paid on the employee's behalf.

of $1.4 billion over the 2008–2012 period. (That estimate includes reductions in individual income tax revenues because a portion of the additional SECA taxes are tax-deductible.) Off-budget SECA receipts, which are credited to the Social Security trust funds, would increase by $0.8 billion over that five-year period. (The option would require a slight change in Schedule SE, the income tax form for reporting self-employment income.)

The main rationale for calculating taxable wages in the same way regardless of employer would be to make the tax system more equitable. That change would ensure that people with the same total compensation paid the same amount of payroll tax.

One drawback to this option, however, would be the complexity that it would introduce into the structure of FICA taxes. The Social Security tax would need different taxable maximums for employees and self-employed people, and different methods of calculation would have to be used to determine tax liabilities for the two groups of workers.

Option 41

Increase Federal Employees' Contributions to Pension Plans

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+0.3	+0.6	+0.9	+0.9	+1.0	+3.7	+9.0

Source: Congressional Budget Office.

Most workers covered by the Civil Service Retirement System (CSRS)—the older of the two major retirement plans for civilian employees of the federal government—are required to contribute 7 percent of their salary to their retirement fund in exchange for a defined-benefit pension. (In a defined-benefit plan, the level of benefits is set by formula and is not affected by the amount an employee contributes.) CSRS workers do not pay Social Security payroll taxes, however. Employees covered by the other main plan for federal civilian workers, the Federal Employees Retirement System (FERS), must generally contribute at least 0.8 percent of their salary toward a defined-benefit plan and pay 6.2 percent in Social Security taxes. Both CSRS and FERS employees are also allowed to make voluntary contributions (up to the Internal Revenue Service's limit of $15,500 in 2007) to the Thrift Savings Plan, the government's counterpart to a defined-contribution 401(k) plan.

This option would raise the contributions that most federal civilian workers would have to make to their defined-benefit retirement plan by 0.5 percentage points relative to current levels. The increase would be phased in over several years, starting at 0.25 percentage points in calendar year 2008, growing to 0.4 percentage points in 2009, and finally reaching 0.5 percentage points in 2010. (Those increases match the ones that the Balanced Budget Act of 1997 imposed through 2002.) Adopting those changes for federal civilian employees would boost revenues by $0.3 billion in fiscal year 2008 and by a total of $3.7 billion through 2012 (assuming that the retirement contributions that agencies made on behalf of their employees were unchanged, as was the case under the Balanced Budget Act).

The main rationale for requiring federal workers to pay more for their retirement plans is to make the government's costs for civilian pension benefits more like those of private-sector employers, without reducing the level of salary replacement that workers receive once they retire. Raising the contributions of current employees would arguably be better than cutting the benefits paid to current retirees (the approach in Option 600-3), because workers could accommodate the effective pay cut by making smaller adjustments to their spending over a larger number of years. (Some employees could choose to maintain their previous take-home pay by reducing their contributions to the Thrift Savings Plan.)

An argument against raising employees' retirement contributions is that the increases would be roughly equivalent to a 0.5 percent pay cut for most federal civilian workers and thus would diminish the government's compensation package relative to that of the private sector. (The large private firms that still offer defined-benefit plans seldom require employees to contribute to them.) Those factors could weaken the government's ability to attract new personnel and might cause it to have to increase cash compensation for its employees or settle for having a less skilled workforce.

RELATED OPTIONS: 600-2, 600-3, and 600-4

RELATED CBO PUBLICATIONS: *Comparing the Pay of Federal and Nonfederal Law Enforcement Officers,* August 2005; *Measuring Differences Between Federal and Private Pay,* November 2002; *The President's Proposal to Accrue Retirement Costs for Federal Employees,* June 2002; *Comparing Federal Employee Benefits with Those in the Private Sector,* August 1998; and *Comparing Federal Salaries with Those in the Private Sector,* July 1997

Option 42

Modify the Estate and Gift Tax Provisions of EGTRRA

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues							
Alternative 1	0	0	-0.8	-23.8	-50.2	-74.8	-400.9
Alternative 2	0	0	-0.7	-19.4	-45.8	-65.9	-366.6
Alternative 3	0	0	-0.2	-1.0	-28.8	-30.0	-231.9
Alternative 4	-2.1	-1.4	-3.1	-36.0	-59.8	-102.4	-498.8

Source: Joint Committee on Taxation.

When someone dies, an estate tax is imposed on the value of his or her assets that are transferred at death, and a gift tax is paid on the value of taxable gifts that were made during the decedent's lifetime. Only the portion of an estate that exceeds a certain amount (currently $2 million) is subject to the estate tax. Likewise, only taxable gifts that exceed the lifetime exemption amount ($1 million) are subject to the gift tax. (Those two exemptions are not cumulative; the exemption amount under the estate tax is reduced by any exemption used under the gift tax.) Gifts and bequests between spouses and bequests to charities are not subject to taxation.

Before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) was enacted, the estate and gift taxes were a single unified levy, with a common exemption amount and rate schedule that applied to the cumulative taxable transfers made by a taxpayer during life and at death. EGTRRA created different exemption amounts for the two taxes. Moreover, under the law's provisions, the estate tax is gradually being phased out until it is repealed in 2010, whereas the gift tax is being retained. (EGTRRA also phases out and then repeals generation-skipping transfer taxes. Those taxes were designed to prevent people from being able to avoid some estate taxation by transferring assets, either as gifts during their lifetime or as bequests, to individuals more than one generation younger than the transferor.)

EGTRRA phases out the estate tax primarily by increasing the amount of an estate that is exempt from taxation and by reducing the top marginal tax rate (the rate that applies to the last dollar of an estate). Under the law, the exemption amount is scheduled to rise from $2 million in 2007 and 2008 to $3.5 million in 2009, while the top marginal rate has fallen from 46 percent in 2006 to 45 percent for 2007 through 2009. In 2010, the estate tax is repealed entirely (as are generation-skipping transfer taxes).

In repealing the estate tax, EGTRRA also temporarily changes the way in which basis is calculated for assets transferred from a decedent. Basis comes into play when inherited assets are eventually sold and capital gains (or losses)—and any applicable taxes—are calculated. A capital gain or loss is measured as the proceeds received from the sale of an asset minus the taxpayer's basis in the asset (which represents his or her original cost for it). Through 2009, "stepped-up basis" will continue to apply to assets transferred from a decedent. In that treatment, basis is generally measured as an asset's fair market value on the date of the decedent's death or on an alternate valuation date, as specified by law. However, EGTRRA specifies that in 2010, a modified "carryover basis" be used for inherited assets whose increase in basis exceeds $1.3 million (or $4.3 million if a spouse inherits the assets). Under modified carryover basis, the basis of those assets in the hands of the heir is generally the same as it was in the hands of the decedent.

For the gift tax, EGTRRA set the exemption amount at $1 million beginning in 2002. That tax's top marginal rate is due to decline in 2010 from 45 percent to a rate equal to the highest rate of the individual income tax, which is currently scheduled to be 35 percent in that year.

All of those provisions of EGTRRA are set to expire on December 31, 2010. Thus, under current law, the estate tax is due to return in 2011 in its pre-EGTRRA form: unified with the gift tax, having a top marginal rate of 55 percent and a combined exemption amount of $1 million, and using stepped-up basis. (An additional

5 percent surcharge will apply to estates worth between $10 million and $17 million.)

EGTRRA's provisions also address state death taxes. Previously, estates could use a credit to lower their federal estate tax liability by the amount of state death taxes they paid (up to a certain level). EGTRRA gradually repealed that credit and, in 2005, replaced it with a deduction that reduces a taxable estate by the amount of such taxes paid to any state or the District of Columbia. In 2011, when EGTRRA expires, that deduction will again be replaced by a credit.

Because of the various changes included in EGTRRA, far fewer estates are subject to the estate tax than would have been the case otherwise. For example, without EGTRRA, about 30,400 estates would have faced the tax in 2005; instead, about 20,000 estates faced it in that year. Similarly, about 38,100 estates would have been subject to the tax in 2010 under prior law, compared with none under EGTRRA.

EGTRRA has made estate planning significantly more complicated, however. People now face not only uncertainty about when they will die and how big their estate will be but also the complexity of legislated phaseouts and repeals and the ultimate reinstatement of the estate and gift tax. EGTRRA has also complicated the process of transferring wealth to heirs before death through the strategic use of gifts (called inter vivos giving), which is a significant part of estate planning for many taxpayers.

This option would modify the scheduled phaseouts and eventual repeal of the estate tax (and generation-skipping transfer taxes) in four alternative ways. The first three approaches would retain and reunify the estate and gift taxes, beginning in 2010; the fourth approach would make EGTRRA's repeal of the estate tax permanent.

- Alternative 1 would set the exemption level for the combined tax at $5 million starting in 2010, index that level for inflation, and set the tax rate equal to the top rate on capital gains (currently scheduled to be 15 percent in 2010 and 20 percent thereafter). Stepped-up basis would apply to assets transferred from a decedent. No deduction or credit would be given for state death taxes. Those changes would reduce revenues by $74.8 billion over the 2008–2012 period. In 2012, approximately 3,000 estates would be required to pay some federal estate tax under this alternative, compared with about 62,000 under current law (following EGTRRA's expiration).

- Alternative 2 would make the same changes as the previous approach, except that instead of a single tax rate, two would apply. The first $25 million of taxable transfers would be taxed at the top capital gains rate, and taxable transfers over $25 million would face a rate of 30 percent. (The $25 million threshold would be indexed for inflation.) This alternative would decrease revenues by $65.9 billion through 2012. In that year, some 5,600 estates would have federal estate tax liabilities under this approach, compared with approximately 62,000 under current law.

- Alternative 3 would set the exemption level at $3.5 million beginning in 2010, index that level for inflation, and set the tax rate at 45 percent. Stepped-up basis would continue to apply to assets transferred from a decedent. But unlike the previous approaches, this alternative would retain EGTRRA's deduction for state death taxes. Those changes would lower revenues by $30.0 billion over five years. About 11,000 estates would have to pay some federal estate tax in 2012 under this alternative, compared with 62,000 under current law.

- Alternative 4 would make EGTRRA's provisions for estate and gift taxes in 2010 permanent rather than temporary. Thus, the estate tax would not be reinstated, and the gift tax exemption would remain at $1 million. In addition, this alternative would permanently retain the modified carryover basis that EGTRRA specifies for certain transferred assets in 2010. Together, those changes would reduce revenues by $102.4 billion over the 2008–2012 period, and no estates would face federal estate taxes in 2012.

In each of those alternatives, the exemption amount for generation-skipping transfer taxes would mirror that of the estate tax.

An advantage of all of the alternatives is that they would provide more certainty about future estate and gift tax law, which would simplify estate planning. Another potential benefit is that they would exempt smaller estates (or, in the case of Alternative 4, all estates) from filing estate tax returns, which would reduce the filing burden for some taxpayers and their heirs. In addition, smaller estates would be less likely to incur estate tax liability—

which, some proponents argue, would reduce the chance that a small business would have to be liquidated after the owner's death to pay estate taxes. Nevertheless, because the first three alternatives would retain the estate and gift tax, returns would still have to be filed for some estates, and some of them would have to pay estate taxes.

Opponents of reducing or repealing estate and gift taxes argue that the progressive nature of those taxes lessens the concentration of wealth in the United States. Another drawback of repealing the estate tax—besides the large loss in revenues—is that charitable giving could decline because taxpayers would no longer have a deduction for leaving bequests to charities. Other opponents of repeal argue that if the estate tax has a negative impact on small estates and closely held businesses (such as family-owned firms), it could be largely avoided by increasing the exemption amount rather than repealing the tax. Moreover, they maintain that even before EGTRRA, very few businesses were forced to liquidate to pay estate taxes. Another consideration is that repealing the federal estate tax would not eliminate the filing burden because many estates would still have to file returns—and pay estate taxes—at the state level.

Analysts hold a variety of views about how estate and gift taxes affect saving, the accumulation of capital, and economic growth. Research in those areas is inconclusive.

RELATED CBO PUBLICATIONS: *Effects of the Federal Estate Tax on Farms and Small Businesses,* July 2005; and *The Estate Tax and Charitable Giving,* July 2004

Option 43

Eliminate the Source-Rules Exception for Exports

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+2.1	+5.2	+5.3	+5.4	+5.5	+23.5	+52.5

Source: Joint Committee on Taxation.

U.S. multinational corporations generally pay U.S. taxes on their worldwide income, including income they earn from the operations of branches or subsidiaries in other countries. Foreign nations also tax the income from those operations, and the U.S. tax code allows a multinational firm to take a limited credit for the foreign income taxes it pays. The credit is subtracted from the U.S. tax that the firm owes on that income, but the credit cannot exceed what the firm would have owed if the income had been earned in the United States. If a corporation pays more foreign tax on its foreign income than it would have paid on otherwise identical domestic income, it accrues what the tax code calls excess foreign tax credits.

Unlike income from companies' operations abroad, income from products that are produced domestically but sold abroad results almost entirely from value created or added in the United States. Hence, the income that U.S. corporations receive from exports typically is not taxed by foreign nations. However, the U.S. tax code's "title-passage" rule specifies that the source of a gain on the sale of a firm's inventory is the place to which the legal title to the inventory "passes." If a firm sells its inventory abroad as exports, the title-passage rule treats the income from those sales in a way that, in effect, allocates half of it to the jurisdiction in which the sale takes place and half to the place of manufacture. In practice, that means that if the firm's inventory is produced in the United States and sold elsewhere, half of the income from the sale is still treated as though it originated from a foreign source, even though the company may have no branch or subsidiary located in the place of sale and the foreign jurisdiction does not tax the income.

The upshot of the title-passage rule is that a firm can classify more of its income from exports as foreign in source than could be justified solely on the basis of where the underlying economic activity occurred. A multinational corporation with excess foreign tax credits can then use the credits to offset U.S. taxes on that income. As a result, about half of the export income that companies with such excess credits receive is effectively exempted from U.S. taxation, and the income-allocation rules essentially give those companies an incentive to produce goods domestically for sale by their overseas subsidiaries.

This option would eliminate the title-passage rule; doing so would require taxpayers to allocate income for the purpose of taxation on the basis of where a firm's economic activity actually occurred. That change would increase revenues by $2.1 billion in 2008 and by $23.5 billion over the 2008–2012 period.

One rationale for eliminating the title-passage rule is that export incentives, such as those embodied in the rule, do not boost overall levels of domestic investment and employment or affect the trade balance. They do increase profits—and thus investment and employment—in industries that sell substantial amounts of their products abroad. But the U.S. dollar appreciates as a consequence, making foreign goods cheaper and thereby reducing profits, investment, and employment for U.S. firms that compete with imports. Thus, export incentives distort the allocation of resources by misaligning the prices of goods relative to their production costs, regardless of where those goods were produced.

Another advantage of this option is that it would end an undesirable feature of the way in which foreign tax credits are granted under U.S. tax law. Those credits were intended to prevent the income of U.S. businesses from being taxed both domestically and abroad. But the title-passage rule allows domestic export income that is not usually subject to foreign taxes to be exempted from U.S. taxes as well, which means that the income escapes corporate taxation altogether.

Opponents of eliminating the title-passage rule argue that the rule is necessary to give U.S. corporations an advantage over foreign companies that operate in the same

markets. (However, companies that lack excess foreign tax credits—such as U.S. exporters that carry out all of their production domestically and some U.S. multinational corporations—receive no such advantage.) Some opponents of this option also argue that allocating income is less complex under the title-passage rule than under the normal rules for income allocation.

RELATED OPTIONS: Revenue Options 35, 44, and 45

RELATED CBO PUBLICATIONS: *International Burdens of the Corporate Income Tax* (Working Paper 2006-09), August 2006; *Corporate Income Tax Rates: International Comparisons,* November 2005; and *Causes and Consequences of the Trade Deficit: An Overview,* March 2000

Option 44

Tax the Worldwide Income of U.S. Corporations as It Is Earned

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.7	+3.5	+3.6	+3.7	+3.9	+16.4	+39.1

Source: Joint Committee on Taxation.

U.S. corporations are subject to U.S. taxes on their worldwide income, regardless of where it is earned. In the case of income earned abroad, the same income may face both foreign and U.S. taxes. To prevent such "double taxation," U.S. companies are allowed to claim the foreign tax credit, which reduces their U.S. taxes by the amount of any income and withholding taxes they have paid to foreign governments. The foreign tax credit is subject to limits that are designed to ensure that the amount of credits taken does not exceed the amount of U.S. tax that would otherwise have been due. Those limits are also intended to prevent corporations from using foreign tax credits as a way to reduce taxes on income earned in the United States. For computing those limits, overhead expenses (such as interest costs) of a U.S. parent company's domestic operations must be allocated between domestic and foreign activities. Most income earned by the foreign subsidiaries of U.S. corporations is not subject to U.S. taxation until it is repatriated in the form of dividends paid to the parent corporation.

Under this option, all income earned by the foreign subsidiaries of U.S. companies would be subject to U.S. taxes as it was earned, regardless of when it was repatriated. To prevent double taxation, foreign tax credits would still be allowed. For determining the limit on those credits, however, the U.S. parent corporation's overhead expenses would no longer be allocated between domestic and foreign activities. Together, those changes would increase revenues by $1.7 billion in 2008 and by $16.4 billion over the 2008–2012 period.

Proponents of this option argue that by not taxing income until it is repatriated as dividends, the current system reduces the cost of foreign investment relative to the cost of domestic investment. In that view, this option would eliminate the bias toward foreign investment and thus increase the amount of domestic investment, which in turn would make U.S. workers more productive and boost their earnings.

Other arguments for this option focus on the benefits of simplifying the tax system. Eliminating the rules for allocating overhead expenses and the provisions that distinguish between active foreign income (which is not taxed until it is repatriated) and passive foreign income (which is generally taxed as it is earned) would make international tax rules less complex. In addition, the costs of tax planning would decline for U.S. multinational corporations because they would no longer have to plan when to repatriate dividends from their foreign subsidiaries. Likewise, the costs of enforcing tax rules would be lower because U.S. companies would not be able to reduce their worldwide taxes by disguising U.S. income as foreign income.

Opponents of this approach argue that it would put U.S. multinational corporations at a competitive disadvantage compared with foreign multinationals: The cost of foreign investments by U.S. multinationals would rise, whereas the cost of foreign investments by foreign multinationals would not change. Opponents maintain that such a competitive disadvantage would shift market share and production toward businesses controlled by foreign multinational corporations.

Concerns of both proponents and opponents of this option could be addressed by reducing U.S. corporate tax rates at the same time. Alternatively, the average U.S. tax burden on U.S. multinational corporations could be held constant by combining this option with a reduction in the top U.S. corporate tax rate.

RELATED OPTIONS: Revenue Options 24, 43, and 45

RELATED CBO PUBLICATION: *Corporate Income Tax Rates: International Comparisons,* November 2005

Option 45

Exempt Active Foreign Dividends from U.S. Taxation

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+2.8	+5.7	+5.9	+6.1	+6.3	+26.8	+61.3

Source: Joint Committee on Taxation.

The United States taxes the income of U.S. businesses regardless of whether it is earned at home or abroad. However, to prevent income earned abroad from being subject to both foreign and U.S. taxation, the tax code allows U.S. corporations to take a tax credit that lowers their U.S. tax liability by the amount of income and withholding taxes they have paid to foreign governments. (The rules governing that foreign tax credit are designed to prevent the credit from exceeding the amount of U.S. tax that would otherwise be owed and to keep companies from using the credit as a way to reduce their taxes on income earned in the United States.) Most of the income that U.S. corporations earn from the business activities of their foreign subsidiaries is not subject to U.S. taxes until it is repatriated in the form of dividends paid to the parent company by its subsidiaries.

This option would exempt from U.S. taxation any dividends that U.S. corporations earned from the business operations of their foreign subsidiaries or foreign branches. Any overhead costs (such as interest expenses) of a U.S. parent company would be allocated between the company's U.S. and foreign activities in the same way that they are now. Unlike in current law, however, overhead expenses allocated to foreign income would not be deductible from U.S. income. All other foreign income would be taxed in the current manner: as it is earned. Foreign tax credits would be allowed so that companies could offset any foreign income taxes or withholding taxes paid on foreign income that would still be subject to U.S. taxation.

Those changes would increase revenues by a total of $26.8 billion through 2012. The revenue lost by exempting dividends from U.S. taxation would be more than offset by increases in taxes on other sources of income. Specifically, taxes on U.S. income would rise because overhead expenses allocated to exempt foreign income could no longer be deducted from U.S. income. In addition, companies that paid high foreign income taxes would no longer be able to use the foreign tax credits associated with repatriated dividends to shield other low-tax foreign income (such as royalties and export income) from U.S. taxes.

Advocates of exempting active foreign dividends argue that such a change would reduce the complexity of the tax system. Under the present rules, U.S. multinational corporations can reduce their worldwide taxes by carefully planning how and when they will repatriate dividend income from each of their foreign subsidiaries. Researchers have estimated the total costs of such planning at more than $1 billion per year. Proponents argue that this option would eliminate those planning costs without affecting the balance between the incentives that companies have to invest in the United States and their incentives to invest abroad. Proponents also argue that this option would allow foreign tax credit rules to be simplified because many of those rules would no longer apply to active dividend income.

Opponents of such a dividend exemption argue that both this option and the current tax system cause U.S. corporations to favor foreign investments over U.S. investments, thus reducing the amount of capital available for production in the United States. That bias could be eliminated by retaining the current system of foreign tax credits but taxing the income of foreign subsidiaries as it was earned (an approach discussed in the previous option) rather than waiting until it was repatriated as dividends.

RELATED OPTIONS: Revenue Options 43 and 44

RELATED CBO PUBLICATION: *Corporate Income Tax Rates: International Comparisons,* November 2005

Option 46

Increase the Excise Tax on Cigarettes by 50 Cents per Pack

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+4.3	+5.6	+5.6	+5.5	+5.5	+26.6	+53.2

Source: Joint Committee on Taxation.

Tobacco is taxed by both the federal government and the states. Currently, the federal excise tax on cigarettes is 39 cents per pack; other tobacco products are subject to similar levies. In 2005, federal tobacco taxes raised a total of $8.7 billion, or about 0.4 percent of federal revenues. At the state level, excise taxes on cigarettes have more than doubled in the past seven years, from an average of 42 cents per pack to 92 cents. In addition, settlements reached with states' attorneys general require major tobacco manufacturers to pay fees that are equal to an excise tax of about 50 cents per pack. Together, those federal and state taxes and fees boost the price of a pack of cigarettes by $1.81.

This option would raise the federal excise tax on cigarettes by 50 cents per pack. That increase would generate $4.3 billion in additional revenues in 2008 and a total of $26.6 billion through 2012. Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions, as well as projected declines in cigarette purchases because of higher after-tax prices. Researchers estimate that each 10 percent increase in the price of cigarettes is likely to cause consumption to fall by 2.5 percent to 5 percent (probably more in the case of teenagers).

In general, the fact that taxing an item can cause consumers to buy less of it than they might otherwise can result in a less-efficient allocation of society's resources—unless some of the costs associated with the taxed item are not reflected in its price. Cigarette use creates "external costs" for society that are not covered in pretax prices, such as higher costs for health insurance (to cover the medical expenses linked to smoking) and the damaging effects of cigarette smoke on the health of nonsmokers. Another problem with tobacco is that consumers may underestimate the harm they do to themselves by smoking or the addictive power of nicotine. Teenagers in particular may not be capable of evaluating the long-term effects of beginning to smoke. Thus, an argument in favor of this option is that raising tobacco taxes would reduce tobacco consumption—and thus its associated costs—by causing cigarette prices to reflect more of the total, long-term costs of smoking that would otherwise be borne by society as a whole and not considered fully by individual smokers.

No consensus exists about the size of smoking's external costs, which makes it difficult to determine the appropriate level of tobacco taxes. Some analysts estimate that those costs are significantly lower than the taxes and settlement fees now levied on tobacco. Others maintain that the external costs are greater and that taxes should be raised even more. Technical issues cloud the debate; for example, the effect of secondhand smoke on people's health is uncertain. Much of the controversy centers on what to include in calculating external costs—such as whether to consider tobacco's effects on the health of smokers' families or the savings in spending on health care and pensions that result from smokers' shorter lives.

One argument against raising cigarette taxes is their regressivity. Such taxes take up a larger percentage of the earnings of low-income families than of middle- and upper-income families, for two reasons. First, lower-income people are more likely to smoke than are people from other income groups. And second, the amount that smokers spend on cigarettes does not rise appreciably with income.

Some opponents of higher cigarette taxes note that the market has mechanisms that already make individual smokers, rather than society, bear many of the costs of smoking—for example, higher insurance premiums for smokers than for nonsmokers and the voluntary establishment of separate smoking areas in restaurants. In that view, such mechanisms and the penalty they exact for smoking eliminate the need to raise taxes in order to reduce costs to society.

Other opponents object to a tax that is intended to protect consumers from a supposed lack of foresight about the harmful effects of smoking. They argue that consumer protection is a specious justification for focusing on cigarette taxes when many other choices that people make—to use alcohol, consume some types of food, engage in risky sports, or work long hours at the office—can also cause unforeseen health or social problems.

RELATED OPTION: Revenue Option 47

Option 47

Increase All Taxes on Alcoholic Beverages to $16 per Proof Gallon

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+4.7	+5.7	+5.8	+5.9	+6.0	+28.0	+59.5

Source: Joint Committee on Taxation.

The federal government collects roughly $9 billion a year from excise taxes on distilled spirits, beer, and wine. The way in which those taxes are levied treats different alcoholic beverages in different ways: Taxes are much lower on the alcohol content of beer and wine than on the alcohol content of distilled spirits because the taxes are figured on different liquid measures. Distilled spirits are measured in proof gallons (a standard unit for the alcohol content of a liquid). The current excise tax rate on those spirits, $13.50 per proof gallon, translates to about 21 cents per ounce of alcohol. Beer, in contrast, is measured by the barrel, and the current tax rate of $18 per barrel translates to about 10 cents per ounce of alcohol (assuming an average alcohol content of 4.5 percent for beer). The current levy on wine is $1.07 per gallon, or about 8 cents per ounce of alcohol (assuming an average alcohol content of 11 percent).

This option would standardize the base on which the federal excise tax is levied by using the proof gallon as the measure for all alcoholic beverages. The tax rate would be raised to $16 per proof gallon, thus increasing revenues by about $4.7 billion in 2008 and by a total of $28.0 billion over the 2008–2012 period. (Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions.)

A tax of $16 per proof gallon would equal about 25 cents per ounce of ethyl alcohol. Under this option, the federal excise tax on a 750-milliliter bottle of distilled spirits would rise from about $2.14 to $2.54. The tax on a six-pack of beer would jump from about 33 cents to 81 cents, and the tax on a 750-milliliter bottle of table wine would increase by a similar amount, from about 21 cents to 70 cents.

The consumption of alcohol creates costs for society that are not reflected in the pretax price of alcoholic beverages. Examples of those "external costs" include alcohol-related spending on health care that is covered by the public, losses in productivity because of alcohol consumption that are borne by others besides the consumer, and the loss of lives and property in alcohol-related accidents and crimes. Calculating such costs is difficult. However, a study done for the National Institute on Alcohol Abuse and Alcoholism estimated that the external economic costs of alcohol abuse exceeded $100 billion in 1998—an amount far greater than the revenues from the current taxes on alcoholic beverages.

Two advantages of raising those taxes would be to reduce alcohol use—and thus the external costs of that use—and to make consumers of alcoholic beverages pay a larger share of such costs. Research has consistently shown that higher prices lead to less alcohol consumption and abuse, even among heavy drinkers. Moreover, raising excise taxes to reduce consumption may be desirable, regardless of the effect on external costs, if lawmakers believe that consumers underestimate the extent of the harm they do to themselves by drinking. Finally, this option would treat different kinds of alcoholic beverages similarly. Such evenhanded treatment is seen by some analysts as beneficial because it avoids distorting consumers' choices among those various beverages.

An increase in taxes on alcoholic beverages would have disadvantages as well. It would make a tax that is already regressive—that takes up a greater percentage of income for low-income families than for middle- and upper-income families—even more regressive. In addition, it would affect not only problem drinkers but also drinkers who impose no costs on society and who thus would be unduly penalized. Furthermore, higher taxes would reduce consumption by some light drinkers whose intake of alcohol has health benefits. Finally, with regard to the argument that drinkers underestimate the costs of alcohol consumption to themselves, some opponents of raising alcohol taxes argue that the government should not try to modify private consumer behavior for reasons other than major external costs to society.

Option 48

Increase Excise Taxes on Motor Fuels by 50 Cents per Gallon

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+49.3	+68.6	+67.4	+67.3	+68.2	+320.8	+685.3

Source: Joint Committee on Taxation.

Revenues from federal taxes on motor fuels are credited to the Highway Trust Fund, which is used to finance highway construction and maintenance. Those taxes are currently levied at rates of 18.4 cents on each gallon of gasoline produced and 24.4 cents on each gallon of diesel fuel. (With state and local excise taxes included, total average tax rates nationwide are 40 cents per gallon for gasoline and 46.5 cents per gallon for diesel fuel.)

This option would raise those federal taxes by 50 cents per gallon, to 68.4 cents for gasoline and 74.4 cents for diesel fuel. That change would increase federal revenues by $49.3 billion in 2008 and by a total of $320.8 billion over five years. (Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions.)

The primary rationale for this option is economic efficiency (allocating society's resources to their most valued uses). Raising taxes on motor fuels would improve efficiency if it caused the price of motor fuel to more accurately reflect "external costs"—costs that fuel use imposes on society that are not reflected in the pretax price of fuel paid by individual consumers. For example, if motor fuels were more expensive, people would have an incentive to drive less or to purchase more-fuel-efficient vehicles, which would lessen the external costs of congestion, accidents, and smog. Lower fuel consumption would also reduce emissions of carbon dioxide and thus could help moderate the effects of human activity on the global climate.

This option envisions a 50 cent rise in tax rates because that increase would bring average nationwide rates on gasoline and diesel fuel to roughly $1 per gallon (including state and local excise taxes). Various studies and public statements by economists have suggested that $1 is the "optimal" excise tax rate on motor fuels. That level is intended to account for several external costs imposed by the overconsumption of motor fuel, including costs associated with pollution, the risk of accidents, and road congestion.

Judging from estimates by analysts at the research organization Resources for the Future, road congestion is the single biggest contributor to the external costs associated with driving. An argument against raising the tax on gasoline is that congestion would be better addressed through other measures, such as tolls or congestion prices (which impose a fee for driving at certain times in certain areas). The President's budget for 2008 proposes policies related to congestion pricing. In the absence of such measures, however, a 50 cent increase in tax rates could partially address those problems.

Other arguments against raising tax rates on motor fuels involve issues of fairness. If the higher fuel prices paid by the trucking industry were passed on to consumers in the form of higher prices for transported retail goods, those higher prices would impose a disproportionate cost on rural households, although the benefits associated with reducing vehicle emissions and congestion are greatest in densely populated, mostly urban areas. Moreover, some analysts argue that taxes on gasoline and other petroleum products are regressive (that is, they take up a greater percentage of the income of lower-income households than of middle- and upper-income households.) Other researchers, however, conclude that the effects of such taxes are proportionate.

RELATED OPTION: Revenue Option 49

RELATED CBO PUBLICATIONS: *The Economic Costs of Fuel Economy Standards Versus a Gasoline Tax*, December 2003; *Testimony on Congestion Pricing for Highways*, May 2003; and *Reducing Gasoline Consumption: Three Policy Options*, November 2002

Option 49

Repeal the Partial Exemption for Alcohol Fuels from Excise Taxes

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.9	+2.7	+2.8	+0.8	n.a.	+8.2	+8.2

Source: Joint Committee on Taxation.

Note: n.a. = not applicable.

Motor fuels of all kinds are subject to excise taxes, but in the case of fuels that are blends of gasoline and alcohol, the tax code provides a credit that producers (or, in some cases, sellers) can use to reduce their excise taxes. Some of those blends contain alcohol fuels produced from renewable sources. The primary fuel of that kind is ethanol, which (in the United States) is made chiefly from corn. Producers of fuels containing ethanol are eligible for an excise tax credit of up to 51 cents per gallon. The exact size of the credit depends on the percentage of alcohol in the fuel. For instance, the credit for gasohol, which is 90 percent gasoline and 10 percent ethanol, is 5.1 cents per gallon.

Lawmakers first reduced the taxation of ethanol-based fuels in the 1970s; as originally formulated, the law directly lowered the excise tax rate on those fuels. In 2004, the rate reduction was changed to an equivalent tax credit, which is scheduled to expire at the end of calendar year 2010.

This option would repeal the tax credit on alcohol fuels, raising revenues by $1.9 billion in 2008 and by a total of $8.2 billion through 2011. (After that, when the credit would have been expired, its repeal would not affect revenues.) Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions.

The existing credit has been justified on the basis that it helps reduce demand for imported oil and provides environmental benefits by encouraging the use of renewable fuels that cause less air pollution when they are burned. The credit is intended to help markets for alcohol fuels develop to the point that those fuels provide an economically competitive supplement to gasoline.

Proponents of repealing the tax credit argue that ethanol currently displaces only about 2 percent of U.S. oil imports and thus provides little protection from price shocks in global oil markets. In addition, recent research from the University of Minnesota, by an advocate of alcohol fuels made from prairie grasses instead of corn, suggests that the United States' entire yearly corn crop could make enough ethanol to displace only about 12 percent of the country's annual gasoline usage.

Some supporters of eliminating the credit also dispute the environmental benefits of using ethanol and argue that regulation or increased excise taxes on motor fuels are better means of achieving environmental goals associated with lower gasoline use. Both ethanol and corn currently require substantial amounts of fossil fuels to produce, which offsets the environmental benefit of using an alternative fuel. Scientists are divided about the net benefit of ethanol use: For example, a Cornell University study concluded that 70 percent more energy was used in making ethanol than was produced by the ethanol itself, whereas a study from the University of California at Berkeley found modest energy savings for corn-based ethanol and higher savings for ethanol made from other plant materials. Supporters of repealing the tax credit argue that, given current production processes and levels, ethanol provides little more, or possibly less, energy than must be used to create it and only a small reduction in fossil fuel use and carbon dioxide emissions. In that view, the credit serves mainly as a transfer payment from taxpayers to corporations that produce ethanol and from consumers of corn products to some U.S. farmers through higher corn prices. (Ethanol-driven demand for corn has been suggested as a cause of recent price increases for Mexican tortillas made from imported U.S. corn.) Thus, proponents of repealing the credit argue that it draws resources into ethanol production that might be better used elsewhere.

Advocates of the current credit point to ethanol's renewability and high oxygen content and note that oxygenated (that is, higher-octane) fuels have the potential to add less carbon monoxide—a major precursor of smog—to the atmosphere than pure gasoline does. Indeed, the use of higher-octane gasoline (which can be oxygenated by substances other than ethanol) during the winter as part of the Environmental Protection Agency's Oxy-Fuels program has reduced carbon monoxide emissions and helped improve air quality in some areas where carbon monoxide concentrations had exceeded federally mandated limits. Supporters of the credit argue that tax advantages are still needed for renewable alcohol fuels, such as ethanol, to be economically viable.

RELATED OPTIONS: 270-3 and Revenue Option 48

RELATED CBO PUBLICATIONS: *The Economic Costs of Fuel Economy Standards Versus a Gasoline Tax,* December 2003; and *Reducing Gasoline Consumption: Three Policy Options,* November 2002

Option 50

Eliminate the Federal Communications Excise Tax and Universal Service Fund Fees

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues							
Eliminate the communications excise tax	-0.6	-0.6	-0.5	-0.4	-0.3	-2.5	-3.3
Eliminate Universal Service Fund fees	-8.8	-9.1	-9.3	-9.5	-9.5	-46.5	-96.9

Sources: Joint Committee on Taxation; Congressional Budget Office.

The federal government levies a 3 percent communications excise tax on the charges that customers pay for certain types of telephone and other telecommunications services. In May 2006, after a series of lawsuits challenged the tax's long-distance component, the Internal Revenue Service (IRS) announced that it would no longer collect taxes on long-distance service and other services "bundled" with it, such as wireless and Internet-based telephone services. That decision left local telephone calling as the only service subject to the communications excise tax.

A variety of telecommunications services are subject to another federal levy: the fees that finance the Universal Service Fund (USF). That fund is intended to promote universal access to telecommunications services in the United States by compensating companies that provide local-telephone or Internet services to high-cost areas; low-income households; and some schools, libraries, and rural hospitals. The fees—which are collected from all U.S. providers of interstate and international telecommunications services—function in effect as another telecommunications excise tax.

This option would eliminate the final component of the federal communications excise tax and the USF fees. Doing away with the excise tax would reduce revenues by $0.6 billion in 2008 and by $2.5 billion through 2012. (Because excise taxes reduce the tax base of income and payroll taxes, lower excise taxes would lead to increases in income and payroll tax revenues. The estimates shown here reflect those increases.) Eliminating the USF fees would reduce federal revenues by a further $8.8 billion in 2008 and by $46.5 billion over five years. (Those estimates reflect only the effect of ending the fees. Lawmakers could choose to reduce spending on programs funded by the USF and thus offset some of the lost revenues.)

The main rationale for eliminating those taxes is that they have negative effects on the allocation of telecommunications resources. In the case of the excise tax, innovations in the communications industry and the recent IRS decision have led to a wide range of untaxed services that are similar to the remaining taxed service. Such innovations include new forms of communication through the Internet as well as the bundling of various services—most commonly, local and long-distance calling offered together as part of wireless service, or a combination of local-telephone and long-distance services offered with dial-up Internet access. The uneven application of the communications excise tax distorts consumers' choices among available services by causing decisions to be based more on the services' relative tax rates than on their relative costs and benefits. The USF fees have much the same distortionary effects. The distortionary impact of those taxes may be greater today than it was in the past, when substituting one communications service for another—such as wireless calling, text messaging, or electronic mail for traditional phone service—was less feasible.

Another rationale for eliminating the excise tax and USF fees involves fairness. Those levies are most likely regressive, in that paying them probably takes up a larger share of earnings for lower-income households than for higher-income ones. Moreover, the communications industry's new untaxed alternative services are generally most used by people with higher income, who have greater access to computers and other communications devices.

An argument against ending the excise tax and USF fees is that (to the extent that the taxable services are used) those levies provide a reliable source of federal revenues. Because they are collected by telephone companies, they are difficult to evade. Furthermore, the distortions that they create could be corrected by extending the levies to

cover similar services that are not now taxed or by eliminating exemptions granted to such groups as nonprofit hospitals and educational institutions. Those alternative approaches would have the advantage of increasing revenues and reducing regressivity. In addition, because USF fees are dedicated to specific programs, eliminating the fees would raise the issue of how or whether those programs would be funded.

RELATED OPTION: 370-6

RELATED CBO PUBLICATIONS: *Factors That May Increase Spending from the Universal Service Fund,* June 2006; and *Financing Universal Telephone Service,* March 2005

Option 51

Impose a Tax on Sulfur Dioxide Emissions

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.0	+1.4	+1.4	+1.5	+1.5	+6.8	+14.7

Source: Joint Committee on Taxation.

Under the Clean Air Act, the Environmental Protection Agency (EPA) sets national standards for ambient-air quality that are designed to protect the public's health and welfare. Those standards apply to various pollutants, including sulfur dioxide (SO_2)—a gas formed from the burning of sulfur-containing fuel (mainly coal and oil) and from metal smelting and other industrial processes. Exposure to high concentrations of SO_2 may aggravate respiratory illnesses and cardiovascular disease. In addition, SO_2 is considered a main causes of acid rain, which is believed to harm surface waters, forests, crops, and buildings. (Another cause of acid rain is emissions of nitrogen oxides, which are discussed in the next option.)

The Clean Air Act Amendments of 1990 established a program to reduce SO_2 emissions, and thus acid rain, through a market-based system of emission allowances. Each allowance provides limited authorization to emit 1 ton of SO_2. EPA distributes the allowances to affected electric utilities on the basis of their past fuel use and the statutory cap on emissions. The law requires that once those allowances are allotted, the annual SO_2 emissions of each utility not exceed the number of allowances it holds. Utilities can trade allowances, bank them for future use, or purchase them at periodic EPA auctions. Companies that are able to abate their SO_2 emissions at relatively low cost have an economic incentive to make reductions and sell their surplus allowances to companies with relatively high abatement costs.

Another SO_2 initiative will take effect in 2010, when EPA begins administering the Clean Air Interstate Rule (CAIR). That rule sets limits on SO_2 emissions for 25 eastern states and the District of Columbia and creates a cap-and-trade program that states can participate in to meet their emissions limit. The CAIR SO_2 trading program will operate concurrently with the acid rain program by using allowances distributed under the latter program and permitting sources in CAIR states to trade allowances with sources in non-CAIR states.

This option would impose an excise tax on SO_2 emissions from stationary sources that are not covered under the acid rain program or CAIR. (Such sources include electricity-generating units that produce less than 25 megawatts of power.) The rate of the tax would be set at $400 per ton, based on information about the price of SO_2 emission allowances. That tax would increase revenues by $1.0 billion in 2008 and by a total of $6.8 billion over the 2008–2012 period. (Because excise taxes reduce the tax base of income and payroll taxes, additional excise taxes would lead to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions.) Under the Clean Air Act Amendments of 1990, major sources of pollutants currently pay fees to cover the costs of the program that provides them with operating permits (which state which air pollutants they are allowed to emit). Basing this option's excise tax on the terms granted in those permits would minimize administrative costs for the Internal Revenue Service.

A rationale for this option is that taxes on emissions can help lessen pollution efficiently. This tax would lead to reductions in SO_2 emissions by encouraging firms whose abatement costs were lower than the tax to cut emissions, while allowing firms whose abatement costs exceeded the tax to continue emitting SO_2 and pay the levy.

A potential objection to such an excise tax is that it would lead to inequitable treatment of different emitters. Companies covered by the acid rain program or CAIR would incur no costs for emissions up to their allowance allocation, whereas companies covered by this option would pay a tax on all of their SO_2 emissions.

RELATED OPTIONS: Revenue Options 52 and 53

RELATED CBO PUBLICATIONS: *Limiting Carbon Dioxide Emissions: Prices Versus Caps,* March 15, 2005; *Uncertainty in Analyzing Climate Change: Policy Implications,* January 2005; *The Economics of Climate Change: A Primer,* April 2003; and *Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program,* June 1998

Option 52

Impose a Tax on Nitrogen Oxide Emissions

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+2.9	+4.2	+4.3	+4.4	+4.6	+20.4	+45.5

Source: Joint Committee on Taxation.

Nitrogen oxides (NO_x) usually enter the air as the result of high-temperature combustion processes such as those found in automobiles and power plants. Emissions of NO_x play an important role in the atmospheric reactions that generate ground-level ozone (smog) and acid rain. They can also irritate the lungs and lower resistance to respiratory infections such as influenza, according to the Environmental Protection Agency (EPA). Nitrogen oxides and pollutants formed from them can be transported over long distances, so those problems are not confined to the areas where NO_x are emitted.

The Clean Air Act mandates that states implement programs to reduce ground-level ozone. Because of the transportability of NO_x and ozone, the law requires upwind states to establish programs that will help downwind states meet statutory standards. In 1998, EPA promulgated a rule, commonly referred to as the NO_x SIP Call, that required many eastern states and the District of Columbia to revise their programs in order to reduce NO_x emissions below the previously mandated levels. The rule did not require specific methods; it simply gave each affected state a target for NO_x emissions. Under the NO_x SIP Call, EPA created the federal NO_x Budget Trading Program, a cap-and-trade arrangement for emission allowances. In that program, sources of emissions are issued a specific number of allowances that entitle them to emit a limited amount of NO_x each year. Firms are required to hold an allowance for each ton of NO_x they emit and are free to buy and sell allowances among themselves. Large electricity-generating units and industrial boilers can participate in the program with the approval of the state in which they are located.

In 2009, the NO_x Budget Trading Program will be replaced by the Clean Air Interstate Rule (CAIR). Issued in March 2005, the rule caps NO_x emissions in 28 eastern states and the District of Columbia and provides two new cap-and-trade programs that states can choose to participate in to meet their NO_x emission limits: an annual program and an ozone-season program.

This option would supplement EPA's initiatives by imposing an excise tax on NO_x emissions from stationary sources in states not covered by the NO_x SIP Call or CAIR. The tax would apply to industrial facilities and commercial operations, including electricity-generating units and industrial boilers. The rate of the tax would be set at $1,000 per ton, based on information about the price of NO_x emission allowances. Taxing NO_x emissions would boost revenues by $2.9 billion in 2008 and by a total of $20.4 billion through 2012. (Because excise taxes reduce the tax base of income and payroll taxes, additional excise taxes would lead to reductions in income and payroll tax revenues. The estimates shown here reflect those reductions.)

Supporters of such a tax argue that it would reduce air pollution in an efficient manner. Sources of pollution that could lower their NO_x emissions at a cost below the tax would have an incentive to do so, while sources with abatement costs higher than the tax could continue to pollute and pay the levy. In that way, this option would encourage further reductions in NO_x emissions below the levels required by current regulations.

A rationale against this approach is that the tax would lead to inequitable treatment of different emitters. Companies covered by the NO_x SIP Call or CAIR would incur no costs for emissions up to their allowance allocation, whereas companies covered by this option would pay a tax on all of their NO_x emissions.

RELATED OPTIONS: Revenue Options 51 and 53

RELATED CBO PUBLICATIONS: *Limiting Carbon Dioxide Emissions: Prices Versus Caps,* March 15, 2005; *Uncertainty in Analyzing Climate Change: Policy Implications,* January 2005; *The Economics of Climate Change: A Primer,* April 2003; and *Factors Affecting the Relative Success of EPA's NO_x Cap-and-Trade Program,* June 1998

Option 53

Impose an "Upstream" Tax on Carbon Emissions

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+11.8	+18.9	+20.3	+21.6	+22.8	+95.4	+228.9

Source: Joint Committee on Taxation.

Scientists have identified carbon dioxide (CO_2)—which is emitted during the burning of fossil fuels (coal, oil, and natural gas)—as a key greenhouse gas that can affect the Earth's climate. However, people disagree about what policies might be appropriate to reduce CO_2 emissions.

This option would tax producers and importers of fossil fuels on the basis of the carbon that is emitted when their fuel is burned. The excise tax would begin in 2008 at $14 per ton of carbon (which translates to $3.82 per ton of CO_2). Thereafter, the tax rate would increase gradually to $18 per ton of carbon ($4.91 per ton of CO_2) by 2018. Such a tax is referred to as an upstream tax because it would be applied at the stage where carbon enters the economy (as opposed to a "downstream" tax on households, businesses, and other entities that consume fossil fuels). At the rates envisioned in this option, the tax would increase revenues by $11.8 billion next year and by a total of $95.4 billion through 2012. (Because excise taxes reduce the tax base of income and payroll taxes, additional excise taxes would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.).

A tax on the production and importation of fossil fuels would lead to higher prices for those fuels as well as for goods and services that require a great deal of carbon-intensive energy (such as from coal) to produce. Those higher prices in turn would create incentives throughout the U.S. economy to reduce carbon emissions.

Ideally, the rate of the tax, measured in dollars per ton, would reflect the damage avoided by emitting one less ton of carbon today. The benefits of reducing those emissions are uncertain, however. Assessing the benefits involves determining the relationship between carbon emissions and the change (and rate of change) in temperature in different parts of the globe, as well as concomitant changes in other aspects of the climate, such as rainfall, severity of storms, and sea levels. It also requires evaluating the possible effects—both harmful and beneficial—of regional climate changes on natural and human systems and calculating the pecuniary value of those effects. Finally, it entails estimating the present value of benefits that may occur in the distant future. Traditionally, analysts apply a discount rate to the value of benefits that occur in the future, thus placing more weight on current costs than on future benefits. But how to discount the future benefits that society would reap from avoiding climate change is a controversial question.

Given how difficult it is to determine the benefits of lowering carbon emissions, any estimate of what tax rate would best balance the current costs and future benefits of emission reductions should be viewed as only a rough approximation. Nevertheless, most supporters of a tax agree that the best approach would be to begin with a modest levy and increase it gradually, thus giving the economy time to adjust to using less fossil fuel and allowing for flexibility in policymaking. One of the most comprehensive attempts to determine the appropriate tax on carbon emissions was undertaken by researchers at Yale University; their estimate provides the basis for the tax in this option.[1] Those researchers assumed that the tax would be levied on carbon emissions worldwide, whereas the tax in this option would apply only to emissions produced by facilities in the United States. Although a worldwide tax would induce low-cost reductions of emissions around the globe, a domestic tax would be borne primarily by U.S. residents. At the same time, the benefits for the climate of any reduction in emissions would be distributed worldwide, with those benefits likely to be greatest in developing countries.

1. See William D. Nordhaus and Joseph Boyer, *Warming the World* (Cambridge, Mass.: MIT Press, 2000), p. 133. The authors suggested a global tax on carbon, measured in 1990 U.S. dollars, that would begin at $9.15 per ton in 2005 and increase to $12.73 by 2015. The Congressional Budget Office used an inflation index (based on a gross domestic product deflator) and linear extrapolation to convert those amounts to the current-dollar figures described in this option.

The desirability of a carbon tax remains controversial. Some opponents argue for a different approach to lowering carbon emissions: They maintain that a fixed limit, or cap, on emissions would be better than a tax because it would provide more certainty about the extent to which carbon emissions would actually be reduced. Other opponents argue that any attempt to limit U.S. emissions in the near term (through either a tax or a cap) would impose a large burden on the economy, could cause carbon-intensive industries (such as aluminum and steel production) to move abroad, and would have uncertain benefits.

RELATED OPTIONS: Revenue Options 51 and 52

RELATED CBO PUBLICATIONS: *Evaluating the Role of Prices and R&D in Reducing CO_2 Emissions,* September 2006; *CBO's Comments on the White Paper "Design Elements of a Mandatory Market-Based Greenhouse Gas Registry,"* March 13, 2006; *Uncertainty in Analyzing Climate Change: Policy Implications,* January 2005; *Shifting the Cost Burden of a Carbon Cap-and-Trade Program,* July 2003; *The Economics of Climate Change: A Primer,* April 2003; *An Evaluation of Cap-and-Trade Programs for Reducing U.S. Carbon Emissions,* June 2001; and *Who Gains and Who Pays Under Carbon-Allowance Trading?* June 2000

Option 54

Reinstate the Superfund Taxes

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.2	+1.8	+1.9	+1.9	+1.9	+8.8	+19.1

Source: Joint Committee on Taxation.

Since 1981, the Environmental Protection Agency's (EPA's) Superfund program has been charged with cleaning up the nation's most hazardous waste sites. Most Superfund cleanups are paid for by the parties that are held liable for contamination at individual sites. In many cases, however, the liable parties cannot be identified, no longer exist, or are unwilling or unable to undertake the job. In such cases, EPA pays for the cleanup and, when possible, tries to recover the costs through subsequent enforcement actions.

EPA-led cleanups and other costs of the Superfund program are funded from an annual appropriation, which lawmakers designate as having two sources: the general fund of the Treasury and balances in the Superfund trust fund (formally, the Hazardous Substance Superfund). In earlier years, revenues credited to the trust fund came mainly from taxes on petroleum and various industrial chemicals and from a corporate environmental income tax. However, authorization for the taxes expired in December 1995, and by the end of 2003, the balance in the trust fund had dwindled essentially to zero.

As the fund's balance dropped, reliance increased on the general fund as a source of appropriated money for the Superfund program. Through 1999, program funding from the general fund never exceeded $250 million a year; from 2000 to 2003, that figure was roughly $600 million to $700 million a year. Since 2004, EPA's appropriation has allowed the program to be financed entirely from the general fund and to draw from the trust fund only "such sums as are available." The trust fund will remain a minor source of money unless it receives a new or renewed stream of revenues.

This option would reinstate the Superfund taxes at their previous levels: excise taxes of 9.7 cents per barrel on crude oil or refined oil products, excise taxes of $0.22 to $4.87 per ton on certain chemicals, and a corporate income tax of 0.12 percent on the amount of a corporation's modified alternative minimum taxable income that exceeds $2 million. Those taxes would yield revenues of $1.2 billion in 2008 and $8.8 billion over the 2008–2012 period. (Because excise taxes reduce the tax base of income and payroll taxes, additional excise taxes would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.)

Proponents of this option argue that reauthorizing the Superfund taxes is consistent with the principle that polluters should pay for any efforts that are needed to address problems they create. In that view, because petroleum products and various chemical feedstocks and derivatives are common sources of contamination at Superfund sites, and medium-sized and large corporations are often significant users of hazardous chemicals, it is appropriate that producers and users of such substances—as well as corporations more broadly—foot much of the bill for cleaning up those sites. Some advocates of renewed taxation also argue that the Superfund program needs a stable source of funding, for two reasons: to maintain multiyear cleanup efforts at the largest sites, and to continue to provide a credible threat that EPA will clean up sites and then recover the costs from liable parties who do not undertake the work themselves.

Some critics of reinstating the taxes argue that the Superfund program should not be given dedicated funding until lawmakers reform its liability system and clarify its future mission. Other opponents maintain that taxing all firms in an industry or all corporations above a certain size, regardless of their individual past or present waste-disposal practices, is inconsistent with the efficiency and fairness goals of the "polluter pays" principle. Such taxes provide no incentive for companies to handle waste carefully or, better yet, to avoid creating it in the first place. Instead, the taxes merely distort economic decisions, thus interfering with efficiency rather than furthering it. Moreover, the burden of paying such taxes falls on firms' current stakeholders (customers, employees, and

investors), who may not be the same parties who benefited from or were responsible for past polluting activities.

Opponents of reinstating the Superfund taxes also point to research showing that such levies have high administrative and compliance costs compared with the relatively small amounts of revenue that they raise. Finally, tax opponents note that Superfund spending has always been subject to annual appropriations and that dedicated taxes thus provide no guarantee of stable funding.

Option 55

Extend the Gas-Guzzler Tax to Vehicles with a Gross Weight of 6,000 to 10,000 Pounds

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+2.8	+3.0	+2.0	+0.9	+0.7	+9.4	+13.0

Source: Joint Committee on Taxation.

Under the Energy Tax Act of 1978, most automobiles whose fuel economy is below a certain level are subject to a "gas-guzzler" excise tax. For example, if an automobile belongs to a model type whose adjusted fuel economy rate is less than 22.5 miles per gallon (mpg), the manufacturer must pay a tax on each of those vehicles that it sells. (The adjusted mpg rate is a combined fuel economy measure that is calculated by assuming 55 percent city driving and 45 percent highway driving.) The lower the gas mileage of the model type, the higher the tax. The maximum tax is $7,700 per vehicle for models with mileage of less than 12.5 mpg.

In practice, few vehicles are subject to the gas-guzzler tax, for several reasons. First, the tax does not apply to vehicles that are rated at more than 6,000 pounds unloaded gross vehicle weight (GVW). Second, it does not apply to minivans, trucks, or sport utility vehicles (SUVs)—a group collectively known as light trucks—in part because the tax code exempts "nonpassenger vehicles," which the Department of Transportation defines to include pickup trucks; vans; and most minivans, SUVs, and station wagons. (In 1978, when the tax began, light trucks accounted for about 27 percent of motor vehicles sold at the retail level; by 2005, their share of the market had grown to 50 percent.) Third, the tax is imposed on the basis of the gas mileage of the model type to which a vehicle belongs. Those types are defined by the Environmental Protection Agency; each category comprises different vehicles that have one or more construction features in common. Hence, a vehicle with gas mileage of only 15 mpg may not be subject to the gas-guzzler tax because it belongs to a model type that has an average fuel economy of more than 22.5 mpg.

This option would extend the gas-guzzler tax to light trucks by increasing the tax's weight limit to 10,000 pounds unloaded GVW, repealing the exemption for so-called nonpassenger vehicles, and calculating the tax per vehicle instead of on the basis of model type. Those changes would increase revenues by $2.8 billion in 2008 and by a total of $9.4 billion over five years. (Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.)

Supporters of extending the gas-guzzler tax argue that excluding light trucks gives people an incentive to buy those vehicles instead of smaller, more energy-efficient ones. Vehicles with low gas mileage generate more pollution than vehicles with higher mileage do, so removing the incentive to purchase less-efficient vehicles by taxing them could reduce pollution. Although the gas-guzzler tax was intended to encourage the manufacture and sale of energy-efficient vehicles and the reduction of pollution, it has been less effective than it might have been because certain vehicles have been exempt.

Opponents of expanding the tax argue that many light trucks are used for commercial purposes and that this option would impose a burden on businesses that have economic reasons to buy larger vehicles. Another argument against extending the tax is that many light trucks carry more passengers than cars do, so pollution per passenger-mile may be lower for those vehicles than for cars. Some critics of this option argue that the gas-guzzler tax is an inefficient means of addressing the "external costs" associated with fuel use (costs to society that are not reflected in the pretax price of fuel that individuals pay). In that view, broadening the tax would be less efficient than eliminating it and replacing it with either a tax on the pollution emitted by cars and light trucks or a tax directly on energy use (such as a gasoline tax).

RELATED OPTION: Revenue Option 48

RELATED CBO PUBLICATION: *Fuel Economy Standards Versus a Gasoline Tax,* March 9, 2004

Option 56

Eliminate Tax Credits for Producing Unconventional Fuels and Generating Electricity from Renewable Energy Resources

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+1.3	+2.0	+1.6	+1.3	+1.3	+7.5	+12.5

Source: Joint Committee on Taxation.

Under current law, businesses that produce unconventional fuels or generate electricity from certain renewable forms of energy can claim a credit against their income taxes. Section 29 of the Internal Revenue Code offers credits to producers of natural gas from coal seams (known as coalbed methane), oil from shale and tar sands, gas from geopressured brine and Devonian shale, energy from biomass (including landfill methane), and synthetic fuels from coal. Section 45 of the code offers credits to producers of electricity from wind, closed- and open-loop biomass, and poultry waste.

The tax credits were enacted to promote energy security and efficiency (by encouraging consumers to use alternatives to imported petroleum as well as energy that would otherwise be lost) and to foster a cleaner environment (by encouraging the use of nonpolluting sources of energy). The credits may cause some manufacturers to reduce the price of energy from those sources or to earn larger profits. Lower prices or larger profits in turn can lead to greater reliance on unconventional forms of energy.

This option would eliminate the section 29 and section 45 tax credits. Doing so would increase revenues by $1.3 billion in 2008 and by a total of $7.5 billion through 2012.

Advocates of ending the credits argue that the energy sources they benefit do not contribute significantly to meeting the nation's energy needs. Of those sources, only coalbed methane, landfill methane, and wind power have become commercially viable, and their success is attributable to various factors in addition to the tax credits, including technological advances, rising natural gas prices, other federal programs (such as the Environmental Protection Agency's New Source Performance Standards), and subsidies from the states. In addition, the credits may reduce economic efficiency by encouraging the use of relatively expensive fuels. Indeed, recent research suggests that wind power and biomass energy would not currently be cost-competitive with natural gas in the absence of tax credits.

Furthermore, supporters of eliminating the credits claim that far from benefiting the environment, energy production from some of the eligible sources causes environmental problems. For example, wind rotors may endanger migratory birds, and some methods of producing coalbed methane contaminate groundwater and surface water. Some analysts also say that the goal of promoting a cleaner environment could be achieved more efficiently by imposing taxes on pollutants that reflect the damage those pollutants cause (as in Revenue Option 53, which would create an upstream tax on carbon emissions).

Opponents of this option maintain that the tax credits are an important part of the nation's policy to promote the development of new energy sources and that they help curb wasteful and polluting practices. For instance, capturing landfill methane as a fuel rather than venting it into the air reduces odors and other hazards associated with such emissions. Using poultry waste as a fuel lessens the negative side effects (such as water pollution and unpleasant odors) that are associated with traditional means of disposing of animal waste. In addition, to the extent that the tax credits encourage the use of renewable sources of energy, they may help moderate the impact of human activity on the Earth's climate.

RELATED OPTIONS: 270-1, 270-2, 270-3, and Revenue Options 28 and 53

RELATED CBO PUBLICATION: *The Economics of Climate Change: A Primer,* April 2003

Option 57

Impose Fees on Users of the Inland Waterway System

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+113	+251	+532	+546	+561	+2,003	+5,040

Source: Congressional Budget Office.

Note: Fees collected under this option could also be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

In recent years, the Army Corps of Engineers spent about $800 million annually on the nation's system of inland waterways. About 40 percent of that spending was devoted to construction of new navigation channels, locks, and other infrastructure, and about 60 percent was used for the operation and maintenance (O&M) of existing infrastructure. Current law allows up to half of the Corps's new construction on inland waterways to be funded with revenues from the inland waterway fuel tax, a levy on the fuel consumed by the towboats that use most segments of the system. The Corps receives funds from the Treasury for the remaining costs of construction and operation and maintenance.

This option would impose fees high enough to fully recover the Corps's costs for both construction and O&M on inland waterways. Those fees—which could take the form of higher fuel taxes, charges for the use of locks, or fees based on the weight of shipments and the distance they travel—would generate revenues of $113 million in 2008 and $2 billion over five years. (Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.)

The principal rationale for this option is that it would increase economic efficiency. Imposing fees on the basis of the actual cost of the inland waterway system would encourage shippers to choose the most efficient routes and modes of transportation (air, rail, road, or water). In addition, more-efficient use of existing waterways could reduce the demand for new construction to alleviate congestion. Further, fees based on costs would send market signals that would help identify which additional construction projects would be likely to provide the greatest net benefits to the public.

The effects of such fees on efficiency would depend largely on whether the fees were set at the same rate for all segments of a waterway or were based on the cost of each segment. Because costs vary dramatically by segment, systemwide fees would offer weaker incentives for the efficient use of resources.

A rationale against this option is that higher fees might slow economic development in some regions dependent on waterway commerce. The increase could be phased in to lessen those effects, but doing so would reduce revenues in the near term. Imposing higher fees also would reduce the income of barge operators and shippers in some areas, although those losses would be small in the context of overall regional economies.

RELATED OPTION: 400-7

RELATED CBO PUBLICATION: *Paying for Highways, Airways, and Waterways: How Can Users Be Charged?* May 1992

Option 58

Impose Fees That Recover the Environmental Protection Agency's Costs Related to Pesticides and New Chemicals

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+7	+20	+30	+40	+40	+137	+337
Change in Outlays	-5	-11	-16	-21	-21	-74	-179

Source: Congressional Budget Office.

Note: Negative numbers for the change in outlays indicate an increase in collections that are counted as an offset to federal spending. Those collections could be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

Under the Federal Insecticide, Fungicide, and Rodenticide Act, the Environmental Protection Agency (EPA) registers pesticide products sold or used in the United States. Registration involves assessing a pesticide's potential effects on human health and the environment and determining what methods and types of use meet acceptable standards of safety. For pesticides used on food crops, EPA also is required by the Federal Food, Drug, and Cosmetic Act to set limits on the amount of residue that can remain in food commodities. (Those limits are enforced by the Food and Drug Administration.) Similarly, the Toxic Substances Control Act requires EPA to review new chemicals before they are produced domestically or imported into the United States. In the Premanufacture Notification (PMN) program, manufacturers and importers must give the agency 90 days' notice of their intent to introduce a chemical into commerce, during which time EPA may approve, impose conditions on, or ban the substance.

EPA collects certain fees—classified variously as revenues, offsetting receipts, and offsetting collections—from participants in its pesticide and new-chemical programs. For example, the pesticide program has a schedule of 90 different registration fees that vary according to the type of pesticide (conventional, antimicrobial, or biochemical), the type of registration (new product, new use, new active ingredient, and so on), and the type of use (indoor or outdoor, first use on a food crop, additional food use, nonfood use, and so on). Current registration fees range from $1,500 for a new "me-too" product (that is, a product whose active ingredient is already registered) to $551,250 for a new active ingredient submitted for food use and an experimental-use permit. However, current fees cover only about one-fifth of EPA's costs to administer the pesticide programs and one-fourth of its costs to administer the PMN program, according to the President's 2008 budget, in part because of various statutory constraints on fee categories and levels. For example, PMN fees are limited to $2,500 per submission, which may contain up to six related chemicals. (Small businesses pay only $100 per PMN submission.)

This option, consistent with a proposal in the President's budget for 2008, would raise existing pesticide fees, institute a new fee to cover the costs of the registration review program, and eliminate the current prohibition against collecting fees for food tolerance studies, with the result that total fees would cover roughly half of EPA's costs for implementing the pesticide programs. For the sake of illustration, if the existing fees were doubled (covering 40 percent of the agency's costs, with the new fees accounting for another 10 percent), registration fees would range from $3,000 to $1.1 million. The option also would eliminate the statutory limit of $2,500 on the PMN fee and allow EPA to recover all of that program's costs. The new fee would be on the order of $10,000 per submission. Together, those changes would improve the budget balance by $12 million in 2008 and by $211 million over five years. (Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in revenue from income and payroll taxes. For the portion of those totals classified as revenues, the estimates shown here reflect those reductions.)

An argument in favor of this option is that higher fees would appropriately shift more of the costs of the pesticide and PMN programs from taxpayers in general to the parties who benefit from them directly. An argument

against raising pesticide fees is that the increases would raise farmers' costs for pesticides and could ultimately lead to higher food prices. An argument against raising the PMN fees is that the Toxic Substances Control Act effectively grandfathers older chemicals, so higher PMN fees would increase a bias that favors them over new chemicals, even though the older ones may also be problematic. In both cases, to the extent that the fees collected flowed directly to EPA, rather than to the general Treasury or to a fund subject to the appropriation process, the agency would have less incentive to monitor and control the costs covered by the fees.

RELATED OPTION: Revenue Option 54

Option 59

Charge for Examinations of State-Chartered Banks

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+93	+95	+97	+99	+101	+485	+1,024

Source: Congressional Budget Office.

Bank supervision consists of monitoring an institution's activity and financial condition in order to ensure its safe and sound operation and to assess risks to the federal Deposit Insurance Fund. Although nationally chartered banks and savings associations pay assessments for that federal supervision, state-chartered banks do not.

This option would charge state-chartered banks fees to cover the cost of their examinations by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). Charging the 5,700 state-chartered banks (about 900 of which are supervised by the Federal Reserve and about 4,800 of which by the FDIC) for examinations would increase the revenues remitted by the Federal Reserve by $93 million in 2008 and $485 million over five years. The collections by the FDIC would probably be used to provide a corresponding reduction in deposit insurance premiums, which currently are used to pay the cost of examinations for all state-chartered banks. Any fees that the Federal Reserve charged banks would lead to reductions in revenues from corporate income taxes. The estimates shown here reflect those reductions.

The primary advantage of charging fees for examinations of state-chartered banks would be to make federal treatment of insured financial institutions more uniform. By assessing such fees, the FDIC could cover its examination costs without using resources from the Deposit Insurance Fund, making the cost of deposit insurance for nationally chartered and state-chartered depositories more equitable. The FDIC could then correspondingly reduce the required deposit insurance premiums, as described.

A disadvantage is that the fees could result in somewhat higher costs for state-chartered banks because the banks already pay examination fees to state regulatory agencies. (Imposing examination fees on state-chartered banks might lead some to apply for a national charter, depending on the level of the new fees and the benefits of a national charter. The Congressional Budget Office's estimates incorporate an assumption that the number of state-chartered banks examined by the Federal Reserve and the FDIC remains constant over the period.)

Option 60

Fund the Commodity Futures Trading Commission Through Fees

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+76	+78	+81	+84	+86	+405	+884

Source: Congressional Budget Office.

Note: Fees collected under this option could also be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

The Commodity Futures Trading Commission (CFTC) is responsible for the oversight and regulation of trading in commodity and financial futures and options. Some of the most actively traded securities, such as interest rate and stock market index derivatives, are listed on exchanges regulated by the CFTC. Many of those securities and markets are similar to those overseen by the Securities and Exchange Commission (SEC). Currently, the SEC's operating costs are funded from fees on transactions involving securities regulated by the agency. In contrast, the CFTC does not charge fees and is funded through general tax revenues.

This option would levy fees on transactions in securities regulated by the CFTC. Those fees would be based on transactions in futures and options contracts in proportion to the trading volumes or the relative costs they bring about for the CFTC and would be adjusted periodically by lawmakers to cover the agency's operating costs. For the purpose of this option, gross receipts from the fees are set to equal the agency's projected operating costs, whereas the estimated increases in revenues incorporate the effect that the fees would have in reducing the tax bases for income and payroll taxes. On the basis of trading volumes reported by the CFTC for 2006, a uniform fee of about 4 cents per transaction would be sufficient to cover the agency's 2008 operating costs (excluding effects on income and payroll taxes). However, because a uniform per-transaction fee carries the potential to distort market activity by driving out trades on options with a very low market price, a fee structure could be developed that would charge a fee based on the value of each transaction involving options and a uniform per-transaction fee on futures. (Futures contracts typically have a value of zero at their inception: The terms of the contract are set so that the expected gains and losses to both parties are zero.) That alternative would require tracking the dollar value of options that are traded, a practice that is not currently in place in the markets.

The primary advantage of this option is that it would require participants in markets regulated by the CFTC to fund the cost of oversight. Another advantage is that it would align the costs of regulating similar transactions serving the same economic purpose—such as a trade involving a security in the cash market (for which the SEC charges fees) and a comparable trade in the derivatives market (for which the CFTC does not)—with the entities that benefit from the efficient performance of those markets.

The main disadvantage of this option is the possibility that levying transaction fees on securities traded in the United States might lead some trading to move to foreign markets. That risk would be greatest for high-volume futures traders, for whom a fixed per-contract fee could mean a significant increase in transaction costs. For such traders (handling more than 50,000 contracts per month), transaction costs can be as low as 25 cents per contract, so a fee of 4 cents would represent a relatively large percentage increase in their costs.

Option 61

Impose Fees to Help Fund the Federal Railroad Administration's Rail-Safety Activities

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	0	+34	+71	+73	+73	+251	+643

Source: Congressional Budget Office.

Note: Fees collected under this option could also be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

The Federal Railroad Administration (FRA) conducts a variety of activities designed to protect railroad employees and the public by ensuring that passenger and freight trains operate safely. It establishes standards and procedures, issues regulations, administers drug testing to railroad employees at random intervals and after accidents, provides technical training to railroad workers, and manages highway grade-crossing projects. In addition, the FRA's field-safety inspectors are responsible for enforcing federal safety regulations and standards.

This option would impose fees on railroads to partially offset the costs of the FRA's rail-safety activities. As an example, a fee could be assessed on the basis of each mile traveled by freight and passenger railroads. According to the FRA's Office of Safety Analysis, freight and passenger trains traveled almost 800 million miles in 2005. If that figure remained constant in the future, a per-mile fee of about 13 cents could be charged to fund the FRA's rail-safety activities. Receipts from those fees would total $251 million over the next five years. (Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.)

The main rationale for such fees is that most benefits of rail-safety activities accrue to passengers and freight shippers, as well as to railroad employees, and users should thus pay for those costs. Such fees, which have been imposed in the past, would relieve the general federal taxpayer of some of the burden of funding the FRA's rail-safety programs. (The Omnibus Budget Reconciliation Act of 1990 required railroads to pay fees to cover the administrative and safety-enforcement costs of carrying out the FRA's mandated safety activities. Those fees expired in 1995.)

A rationale against reinstating such fees is that the general public realizes benefits from the FRA's rail-safety activities. Moreover, charging for the cost of regulating safety might dissuade railroads from making their own safety improvements.

RELATED OPTIONS: 400-3 and 400-6

RELATED CBO PUBLICATION: *Freight Rail Transportation: Long-Term Issues,* January 2006

Option 62

Increase Fees for Certificates and Registrations Issued by the Federal Aviation Administration

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+11	+12	+12	+13	+13	+61	+135

Source: Congressional Budget Office.

Note: Fees collected under this option could also be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

The Federal Aviation Administration (FAA) runs a large regulatory program designed to ensure the safety of air travel. It oversees and regulates the registration of aircraft, the licensing of pilots, the issuance of medical certificates, and other, similar activities. Under current law, the FAA issues most licenses and certificates free of charge or at prices well below its costs. For example, the current fee to register an aircraft is $5, but the FAA's cost to provide that service is closer to $60. Pilots' certificates are issued free of charge, although the FAA estimates the cost of issuing them at $40 apiece.

This option would increase or impose fees to cover the costs of the FAA's regulatory services. Such changes could increase receipts by $11 million in 2008 and by $61 million over the 2008–2012 period. (Because excise taxes reduce the tax base of income and payroll taxes, higher excise taxes would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.) The net budgetary impact would be somewhat smaller if the FAA needed additional resources to establish and administer the fees.

The primary rationale for this option is that it would recover the FAA's costs of issuing certificates and licenses while charging users relatively modest amounts—especially compared with the total cost of owning an airplane. The charges would be analogous to the fees that people pay to register automobiles or to get drivers' licenses.

A drawback of the option is that higher regulatory fees might impose a burden on some aircraft owners and operators. That effect could be lessened by setting registration fees according to the size or value of an aircraft rather than on the basis of the FAA's costs.

RELATED OPTION: 400-6

Option 63

Finance the Food Safety and Inspection Service Solely Through Fees

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+275	+600	+653	+676	+699	+2,903	+6,785

Source: Congressional Budget Office.

Note: Fees collected under this option could also be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

The Food Safety and Inspection Service (FSIS), an agency within the Department of Agriculture (USDA), regulates the safety and labeling of most domestic and imported meat and poultry sold for human consumption in the United States. It also ensures the safety of certain egg products. The FSIS employs more than 7,000 inspectors, one or more of whom must be present at all times when a meat or poultry slaughtering plant is operating. In addition to sampling and testing meat and poultry products, inspectors monitor processing plants daily for adherence to federal standards (for instance, those governing sanitary conditions, ingredient levels, and packaging). Recently, the FSIS has also been charged with protecting the nation's meat and poultry supply from bioterrorism. The agency gets most of its funding through annual appropriations, which total $887 million in 2007. However, when plants operate during holidays or overtime shifts, the meat-packing industry pays the government for FSIS inspectors through fees.

This option would finance all federal meat and poultry inspection activities (not just those that occur during holidays or overtime shifts) with fees paid by meat and poultry slaughtering and processing firms. Implementing such a change would increase federal revenues by $275 million in 2008 and by a total of $2.9 billion over five years. (Because such fees reduce the tax base of income and payroll taxes, the new fees would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.) The President's 2008 budget recommends an increase in the collection of fees to finance inspection activities, but not to the extent considered in this option.

An argument in favor of this option is that users of government services should pay for those services. Federal inspections benefit both producers and consumers of meat and poultry products because they prevent diseased animals from being sold as food. But the meat and poultry industries benefit in other ways as well. For example, they can advertise that their products have been inspected by the USDA, which may enhance the quality of those products in the eyes of consumers.

An argument against this option is that the current system of public financing benefits society at large, primarily by preventing the spread of disease from infected livestock to other sources of food and water.

Option 64

Establish New Fees for the Food and Drug Administration

						Total	
(Millions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2017
Change in Revenues	+27	+28	+30	+31	+32	+148	+320

Source: Congressional Budget Office.

Note: Fees collected under this option could also be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

The Prescription Drug User Fee Act of 1992 first authorized the Food and Drug Administration (FDA) to collect fees from pharmaceutical manufacturers to help speed up the review of applications for the approval and marketing of new brand-name drugs and biological products (such as vaccines). The program was reauthorized in 2002 and will come up again for reauthorization this year.

This option would establish new fees to pay for the cost to the FDA of regulating two areas: the review of abbreviated new-drug applications filed by manufacturers of generic drugs, and the promotion of brand-name drugs to physicians (a practice known as physician detailing) and to consumers. The new fees would increase governmental receipts to pay for the FDA's costs of regulating those two areas at current workload levels. Taken together, collections of those two fees would boost federal revenues by $27 million in 2008 and by $148 million over the 2008–2012 period. (Because such fees reduce the tax base of income and payroll taxes, the new fees would lead to reductions in revenue from income and payroll taxes. The estimates shown here reflect those reductions.)

Under current law, manufacturers file an abbreviated new-drug application with the FDA's Office of Generic Drugs and obtain the office's approval to market a generic version of a brand-name drug. The office reviews each application to determine whether the manufacturer of the generic drug has demonstrated that its product is biologically equivalent to the brand-name product. The number of applications received by the FDA has increased in recent years, climbing from 479 in 2003 to 777 in 2005. To implement the new fee, the Secretary of Health and Human Services could choose to set the fee for each application submitted to the FDA or for each generic product on the market. Imposing such a fee to pay for the costs of funding the FDA's Office of Generic Drugs at current workload levels would increase federal revenues, on net, by $23 million in 2008 and by $125 million over five years.

The Division of Drug Marketing, Advertising, and Communications within the FDA's Center for Drug Evaluation and Research (CDER) regulates the promotion of prescription drugs, including the detailing of drugs to physicians and direct-to-consumer advertising. In particular, the division requires that pharmaceutical manufacturers submit all drug advertisements to the FDA when they are first disseminated to the public. The FDA's Center for Biologics Evaluation and Research (CBER) regulates similar activities relating to the promotion of biological products on the market through its Advertising and Promotional Labeling Branch. In 2003, a combined total of between 1,500 and more than 2,000 brand-name drugs and biological products were promoted by manufacturers. The Secretary of Health and Human Services could choose to impose the new fee for each product or for each advertisement. Creating such a fee to pay for the costs of operating CDER's Division of Drug Marketing, Advertising, and Communications and CBER's Advertising and Promotional Labeling Branch at current workload levels would increase federal revenues, on net, by $4 million in 2008 and by $23 million through 2012.

An argument in favor of this option is that the FDA's regulatory activities benefit pharmaceutical manufacturers as well as consumers by certifying the safety and efficacy of their products. Through the new fees, firms and consumers would be faced with the full costs of bringing those products to market, thereby encouraging efficient decisionmaking. Moreover, to the extent that the imposition of such fees might reduce the amount of physician detailing and direct advertising to consumers that occurred, some people argue that such a reduction could be beneficial because drug promotion tends to favor newer, more

expensive drugs (with side effects that may not yet be fully understood) over older, less expensive drugs.

An argument against this option is that the new fees might reduce the number of manufacturers of generic drugs in a given market and lead to somewhat higher prices for those drugs. In addition, if a reduction in the amount of physician detailing and advertising to consumers occurred, some people might argue that such a reduction would be undesirable because those activities provide important information to physicians and the public about new treatments as they become available.

Option 65

Impose Fees on the Investment Portfolios of Government-Sponsored Enterprises

						Total	
(Billions of dollars)	2008	2009	2010	2011	2012	2008-2012	2008-2012
Change in Revenues	+1.6	+1.6	+1.7	+1.7	+1.7	+8.3	+17.6

Source: Congressional Budget Office.

Note: Fees collected under this option could also be recorded in the budget as offsetting collections (discretionary) or offsetting receipts (usually mandatory), depending on the specific legislative language used in establishing the fees.

Government-sponsored enterprises (GSEs), private financial institutions chartered by the federal government, are intended to increase the availability of credit for specific purposes, such as housing and agriculture. They fulfill that role by raising funds in the capital markets partly on the strength of an implied federal guarantee and then lending (or otherwise conveying) moneys to retail lenders. Despite explicit language that the federal government does not formally guarantee those securities, investors who buy them infer that guarantee because of various provisions in the GSEs' charters—including provisions that exempt the enterprises from state and local income taxes and the Securities and Exchange Commission's registration requirements, establish the GSEs' securities as eligible to be collateral for federal and other public deposits, and authorize the Secretary of the Treasury to purchase those securities. That implicit federal guarantee, for which the government collects no fee, lowers the cost of borrowing for the GSEs and enables them to issue large amounts of new debt independently of their financial condition. Studies by the Congressional Budget Office and others have therefore concluded that the GSEs receive significant implicit federal subsidies, which are not fully passed on to mortgage borrowers.

Four GSEs—Fannie Mae, Freddie Mac, Farmer Mac, and the Federal Home Loan Bank System—have used their special borrowing status to acquire and hold large portfolios of securities. Those investments consist mostly of mortgage-backed securities but also include other asset-backed securities, mortgages, corporate bonds, and mortgage revenue bonds. The investment portfolios of the four enterprises total about $2 trillion, or about 75 percent of their combined assets, according to current reports. The GSEs earn profits from the difference in the yields they receive on their investments and the yields they pay on their implicitly guaranteed debt issues. In response to their recent accounting problems, Fannie Mae and Freddie Mac have both agreed to temporary caps of more than $700 billion on their portfolios.

This option would impose fees of 10 basis points (10 cents per $100 of investment) on the GSEs' average daily investment portfolios. Those fees would increase federal revenues by $1.6 billion in 2008 and by $8.3 billion over five years. Proceeds from the fees would equal less than 20 percent of the estimated federal subsidies that the three housing GSEs (Fannie Mae, Freddie Mac, and the Federal Home Loan Banks) have retained (by not passing them on to mortgage borrowers). Because the fees would reduce the tax base of the GSEs' income, imposing them would lead to reductions in revenues from other taxes, principally the corporate income tax. The estimates shown here reflect those reductions. (The Federal Home Loan Banks do not pay federal taxes.)

A number of alternative fees charged to the GSEs could raise similar amounts of money. For example, policymakers could impose annual fees on the GSEs' new purchases of financial assets (including mortgages and mortgage-backed securities). Another approach would be to charge the GSEs for their line of credit with the Treasury, under which the department may purchase GSE securities—up to $2.25 billion from Fannie Mae, the same amount from Freddie Mac, and $4 billion from the Federal Home Loan Banks. Those amounts are small relative to the size of the GSEs' obligations, but the line of credit supports the market's perception of an implied federal guarantee. The GSEs could be given the choice of either paying the annual fees or giving up the line of credit. Also, fees could be set to rise over time.

Imposing fees on the GSEs could promote competition in financial markets and recover some of the implicit federal subsidies those enterprises receive without reducing

their capacity to achieve their public mission. For example, fees would not limit the housing GSEs' ability to guarantee mortgage-backed securities, nor would they hamper the Federal Home Loan Banks' capacity to make advances to member banks. Fees linked to the volume of GSEs' transactions would tie the size of their payments to the size of the implicit subsidies. A rationale for charging fees for the line of credit with the Treasury is that doing so would follow private practice, in that banks and other lenders typically charge fees for open credit lines.

A general disadvantage of imposing fees on the GSEs is that doing so might lead to an increase in interest rates for mortgages and agricultural loans because it would increase the cost of GSEs' operations. A particular disadvantage of imposing fees on the GSEs' portfolios is that investors might interpret the action as strengthening the implicit federal guarantee and thus reducing discipline otherwise imposed by the market. (Charging for the existing line of credit would not strengthen the implicit guarantee because that special privilege is already explicit.) The fees could also reduce the GSEs' incentive to buy mortgage-backed securities, including in periods of financial stress, when the gap between interest rates on most securities and Treasury rates tends to widen.

A particular disadvantage of charging fees for the line of credit with the Treasury is that doing so might limit the department's discretion to deny credit to the GSEs in times of stress. In all likelihood, the GSEs would borrow from the Treasury only if private investors were unwilling to purchase the enterprises' securities. For example, when Fannie Mae was experiencing financial difficulties in the early 1980s, it continued to access the capital markets largely on the strength of its implicit guarantee and did not need to borrow from the Treasury.

RELATED OPTIONS: 370-7 and Revenue Option 37

RELATED CBO PUBLICATIONS: *Measuring the Capital Positions of Fannie Mae and Freddie Mac,* June 2006; *Aligning the Costs and Benefits of the Housing Government-Sponsored Enterprises,* April 21, 2005; *Updated Estimates of the Subsidies to the Housing GSEs,* April 8, 2004; *Regulation of the Housing Government-Sponsored Enterprises,* October 23, 2003; *Effects of Repealing Fannie Mae's and Freddie Mac's SEC Exemptions,* May 2003; and *Federal Subsidies and the Housing GSEs,* May 2001

APPENDIX

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All divisions of the Congressional Budget Office (CBO) contributed to this report, which was coordinated by Arlene Holen and Christian Howlett. Donald Marron provided overall guidance in the preparation of the volume. The staff of the Budget Analysis Division, under the supervision of Robert Sunshine, Peter Fontaine, Thomas Bradley, Kim Cawley, Paul Cullinan, and Sarah Jennings, prepared the spending estimates that appear throughout the report. The staff of the Joint Committee on Taxation prepared most of the revenue estimates. Arlene Holen wrote Chapter 1. Many other people at CBO helped prepare the options:

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